# Chapter 17

General Anti Avoidance (GAAR)

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**Tax Planning, Tax Avoidance & Tax Evasion**

**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, permitted under the Act so to minimize the burden of taxation.

**Examples:**
- Choosing the suitable form of assessable entity (individual, firm, company)
- Choosing suitable forms of investment (share capital, loan capital, lease) considering deductions available in respect of interest, exemption available in respect of dividend etc.
- Diversification of the business activities considering the various profit-linked benefits

**Tax evasion** refers to any attempt to avoid payment of taxes by using illegal means.

**Examples:**
- 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;

Minimization of one’s tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with evasion, which entails the reduction of tax liability by using illegal means.

[Black’s Law Dictionary]
The arrangement is entered into solely or primarily for the purpose of obtaining a tax advantage & does not have any commercial substance.

**Example:**
If a person shift his existing business to a SEZ just to claim the tax benefits u/s 10AA & there is no other commercial consideration involved.
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**DS COMMENT - It is pertinent to note that...**

While it is neither desirable to devise artificial tax planning techniques, it must also be equally noticed that non-avoidance of tax does not mean one must pay tax at the highest possible rates. The transactions which would be frowned upon are those which are fiscally active but commercially inert.

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**DS COMMENT - It is pertinent to note that...**

To curb the tax avoidance strategies adopted by MNEs, OECD and G20 nations came together with BEPS Action Plan. Also, India has implemented General Anti Avoidance Rules (GAAR) to tackle tax avoidance strategies w.e.f A.Y. 2018-19.

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### Applicability of GAAR

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| Tax Mitigation/Tax Planning - involves legal measures with substance to save Taxes  
Eg: Setting up of unit in SEZ to claim exemption u/s 10AA | ☑- This is permissible                        |
| Tax evasion - where the transactions are outright sham, or are concealed  
Eg: diversion of production from non-SEZ unit to SEZ unit just to claim exemption u/s 10AA | ☑- as existing jurisprudence is sufficient to cover tax evasion / sham transactions. |
| Tax avoidance with the use of legal steps resulting in tax reduction, which steps would not have been undertaken if there was no tax reduction | ☑- Covered by GAAR |

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General Anti Avoidance (GAAR)

GAAR vs. SAAR

GAAR- Chap XA

S. 94B Thin capitalization
S.94CE – Sec.Adj

S. 94 – Dividend/Bonus Stripping

S. 94A on transactions with persons located in NJA

S. 93 on avoidance of tax by transfer of income to NR

S. 92 to 92F on transfer pricing regulations

S. 94 – Indirect transfer
S.6 -POEM

S. 2(22)(a)-(e) on deemed dividend

Disallowance of expenses u/s 36, 40, 40A(2), 43B,14A

S.50C/CA/D – Deemed SC
S.56(2)-gifts

S.61-64 – Clubbing Provisions

S. 9 – Indirect transfer
S. 79 – Set-off of losses of closely held co

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

Specific Anti-Avoidance Rules (SAAR)

S. 89 to 92F on transfer pricing regulations

S. 94E Thin capitalization

S.94F – Sec.Adj
Example 1

DS Ltd. 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 transfer pricing regulations that deny tax benefits. Hence, the Revenue would not invoke GAAR in such a case.

Example 2

M/s DS Ltd., having 2 units – Unit A (SEZ Unit) and Unit B (Non-SEZ Unit), started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. 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 would not invoke GAAR in such a case.

Will GAAR be invoked if SAAR applies?

CBDT has stated that 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.

Will GAAR be applied to deny treaty eligibility in a case where there is compliance with Limitation of Benefit (LOB) test of the treaty?

CBDT has clarified that 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.

DS Comment: LOB clause limits the application of treaty benefit to sham entities who does not fulfill certain specified conditions and are incorporated only to claim treaty benefits.
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. The GAAR provisions codify this 'substance over form' basis of the tax law.

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.

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.

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**GAAR Codified [Chapter XA]**

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**Section 90(2A): GAAR Overrides Treaty**

Notwithstanding anything contained in section 90(2), the provision of chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him.
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APPLICABILITY OF GAAR [A.Y. 2018-19]
NOTWITHSTANDING ANYTHING CONTAINED IN THE ACT

1. Assessee enters into an ARRANGEMENT

2. There is TAX BENEFIT > `3 crs (S.102)

3. IMPERMISSIBLE AVOIDANCE ARRANGEMENT

ONUS ON REVENUE

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

3a. PURPOSE TEST

MAIN PURPOSE/one of the main purpose was to obtain TAX BENEFIT

3b. TAINTED ELEMENT TEST

b) results directly or indirectly, in the misuse, or the abuse, of the provisions of this Act

d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bonafide purposes

c) lacks commercial substance or is deemed to lack commercial substance (defined u/s 97) in whole or in part

a) Creates rights or obligations which are not created between persons dealing at ALP
Analysis of the above provision:
1. 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.
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2. The term arrangement is defined u/s 102 and the term impermissible avoidance arrangement is defined u/s 96.
3. 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.
4. 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.

**Impermissible Avoidance Arrangement**

For declaring an agreement as an impermissible avoidance arrangement, twin conditions need to be satisfied:

a) **Purpose test:** 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. The onus of establishing that the main purpose is to obtain a tax benefit is on the tax authority.

b) **Secondary test:** Any of the 4 secondary test needs to be satisfied for invoking GAAR which are discussed in detail below.

### Primary Test

The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit.

**Example:**

Company A is in the business of manufacturing soaps. Company B is in the business of manufacturing caustic soda (a raw material for soaps). Both are independent companies. For having in-house raw material supplies, it was agreed between the companies that Company B will merge with Company A. This also results in tax savings on account of capital gains; getting access to funds of Company B, etc. Company A could also have bought out the assets of Company B. However merger was agreed upon as there would be no tax. In this illustration, business reason was one of the main reasons for merger. Tax benefit was also an important reason but not one of the main purposes. In this situation, GAAR cannot apply.

**Example:**

Consider a similar situation but where Company B is a subsidiary of Company A. Here Company A already has access to raw material of Company B (being its subsidiary). If Company B merges with Company A, will tax benefit be considered as the main purpose or one of the main purposes? In this case, the chances of applicability of GAAR are higher.

**CBDT has clarified that GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.**

The illustration is of returning funds to the shareholder by way of dividend or buyback of shares. Both are legitimate ways of returning funds to shareholders. Just because a particular manner of returning funds to the shareholder reduces tax, it does not mean GAAR should apply. In essence commercial substance has to be satisfied so that GAAR may not apply.
### Section 102: Tax Benefit

The revenue will have to “re-arrange” the facts and arrive at reworked facts. These are known as counter-factuals. The tax will be worked out based on reworked facts. The difference between tax on reworked facts and assessee’s facts will be tax benefit. The revenue will have to rework the facts and compute the tax benefit before a notice is issued to the assessee.

#### Tax Benefit

- **a)** avoidance or deferral of tax or other amount (e.g., surcharge, cess, interest but not penalty) payable under the Act/ as a result of treaty.
- **b)** in a refund of tax or other amount (e.g., surcharge, cess, interest but not penalty) under the Act/ as a result of treaty.
- **c)** \(\downarrow\) in total income
- **d)** \(\uparrow\) in loss
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Secondary Test

a) **Creates rights or obligation which are not created between person dealing at ALP.**

As there are specific transfer pricing regulations (SAAR) applicable to international 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.

**Example:**

DS Ltd, an Indian company, has entered into an agreement for sale of product X to Mr. A (resident) an unrelated party @ `1,000 (goods worth `1,500) on 1st June, 2017 and Mr. A has entered into agreement with SS Inc, a non-resident for sale of product X @ `1,000 on 31st May, 2017. SS Inc holds 45% in DS Ltd.

Examine the implications from the TP and GAAR perspective.

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45%

DS Ltd

Mr. A (Resident) (unrelated party)

SS Inc

A prior agreement was entered between Mr. A & SS Inc (i.e. on 31/05/2017) to purchase goods from DS Ltd and sell to SS Inc. Accordingly, **transaction between DS Ltd & Mr. A would be deemed to be International transaction. Therefore, TP addition shall be made based on the difference between the ALP and the transaction price. Since, transfer pricing (SAAR) is applicable on this transaction, GAAR shall not apply.**

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b) **Results directly or indirectly, in the misuse, or the abuse, of the provisions of this 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.
Facts:

1) Nirma Ltd. ('assessee'), engaged in the business of manufacturing of detergent powder etc., had decided to set up a soda ash manufacturing plant, a product which would be used for the manufacture of soaps and detergent.

2) For setting up the said soda ash plant, the assessee required capital investment estimated at `1037.28 crores which was raised through various sources such as The Rupee Term loan, Foreign Currency loan, internal accruals, amalgamation and `162.83 crores through the rights issue of Non Convertible Debentures ('NCDs') an Secured Premium Notes ('SPNs').

3) The option to subscribe NCDs/SPNs was given to all shareholders, promoters and non-promoters for `200/- each.

4) Although the returns differed on NCDs and SPNs, but the mode of returning the principal sum of `200/- deposited by NCD/SPN holders was identical.

5) Approximately 70% of total fund raised was received from SPN subscribers. Nearly 96% of the SPN was subscribed by promoters, their family members and sister concerns.

6) Vide Board Resolution, NCDs and SPNs were both redeemed prematurely. NCD holders received sum of `237/- per debenture [`200/- of the principal amount and balance towards interest and pre-redemption premium].

7) The assessee in Assessment Year (AY) 1999-2000 claimed the entire expenditure on premium and additional premium on premature redemption of NCDs and SPNs by way of expenditure u/s 36(1)(iii).

8) Prior to the redemption, almost all the SPN holders sold their SPNs to banks and financial institutions at the price ranging from `356/- to `358/- per SPN and offered to tax the difference between the base price and the sale price as long term capital gains (LTCG). The banks and financial institutions offered the difference between their cost of acquisition and the redemption price of `361/- of SPNs to tax.

9) The AO observed that majority of SPNs were subscribed by the promoters and sister concerns of the assessee and before the early date of redemption, all the SPN subscribers transferred the SPNs to the banks/financial institutions.

10) AO argued that the transfer of SPNs took place at the time, when the decision and terms of early redemption was within the public domain and the banks were very much aware about the date and price at which such SPNs would be redeemed. Further, the small margin between the transfer price and the redemption price offered by banks fortified the view that issuance of SPNs was a colourable device to avoid payment of tax and was a premeditated strategy to defraud Revenue.

11) Accordingly, he disallowed the total interest expense claimed by the assessee for the soda ash division and lab project on the ground that the entire device was created to defraud the Revenue.

Held:

1) HC noted that the assessee claimed the entire premium and additional premium amount by way of expenditure amount u/s 36(1)(iii) of the Act.

2) SPN holders offered the difference only by way of capital gains. The banks offered the difference between the purchase price and the redemption price of SPNs by way of profit.

3) HC observed that a free option was given to all the shareholders to subscribe for NCDs/SPNs. Accordingly, it held that the fact that all promoter shareholders' preferred SPNs by itself would not be indicative of any hidden design. Therefore, it held that in what manner the assessee should raise its required funds is essentially a business decision and the Revenue certainly cannot question the priority of the company in this respect.

4) It also noted that when the transfer of SPNs by subscribers to banks took place, the company, investors, banks and financial institutions and all and sundry were aware that the SPNs would be foreclosed and that the company would pay out a sum of `361/- per SPN. Further, the early foreclosure
of the scheme applied as a whole to NCDs as well as SPN holders and was not confined to SPN subscribers.

5) Therefore, it held that if the promoters SPN holders and the banks and financial institutions therefore, traded in such SPNs, the same would not indicate any colourable device of tax planning. Mere early redemption also would not be enough to hold that from the inception there was a device created by the company to defeat the Revenue's interests.

6) It accepted the assessee's contentions that over a period of time, the interest rates in the market fell which would enable the assessee to borrow funds at lower interest rate and therefore, earlier redemption was resorted to. Even if the SPNs were not redeemed early, subscribers were never prevented from transferring the instruments at an early date to the banks and claiming the capital gain, the same way in which they have now done.

7) Therefore, it held that for claiming interest expenditure u/s 36(1)(iii), it needs to be seen that whether it was otherwise an allowable expenditure in terms of the said provision or it was not a colourable device.

8) If the claim of the investors is not genuine, it was always open for the Revenue to disallow it.

9) However, the claim of interest expenditure cannot be disallowed if the claim is otherwise genuine but is not liked by the Revenue.

10) It stated that the entire scheme can be seen as a clever but permissible tax planning and not a sham or a colourable device.

11) There is always a line though not always clear, between legitimate tax planning, even exploiting legal loopholes and sham or bogus device to defeat genuine claim of the Revenue.

12) HC allowed the deduction of interest and premium paid on redemption of SPNs u/s 36(1)(iii).

**DS Comment**

*Now post applicability of GAAR, could Revenue authorities argue that such transaction of SPNs is an arrangement resulting in consequences which are not intended by the legislation, and has an intent to misuse or abuse the law, therefore this is an impermissible avoidance arrangement and GAAR is required to be invoked? Could the Revenue authorities disregard the transaction of SPNs and disallow the interest post invoking GAAR?*

*If the assessee is able to demonstrate that the SPNs were redeemed due the fact that over a period of time, the interest rates in the market fell which would enable the assessee to borrow funds at lower interest rate and therefore, earlier redemption was resorted to. Therefore, the main purpose or one of the main purpose was not to obtain tax benefit. In such situation, since there was commercial consideration and tax was not the only consideration, assessee can come out of clutches of GAAR.*

*However, if the assessee is not able to substantiate the commercial consideration, then GAAR could be invoked as it would be deemed by the Revenue that the early redemption of SPNs was undertaken to obtain the tax benefit.*
c) Arrangement to lack commercial substance:

1. Substance of the arrangement as a whole differs from form of its individual steps
2. Involves:
   - a) Round Tripping
   - c) Elements that have effect of offsetting or cancelling each other
   - d) Transaction which disguises the value, location, source, ownership or control of funds
   - b) Accomodating Party
3. Location of an asset or of a transaction or of the place of residence of any party is without any substantial commercial purpose other than obtaining a tax benefit
4. No significant effect upon the business risks or net cash flows of any party to the arrangement apart tax benefit that would be obtained

#### 1. Substance of the arrangement as a whole differs from form of its individual steps:

It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then 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.

#### 2. a) Round Tripping

Round trip finance has been explained in S.97(2). It includes an arrangement in which through a series of transactions:
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– funds are transferred amongst parties to an arrangement, and
– transactions do not have any substantial commercial purpose.

Normally, Round trip finance is a situation where funds are sent abroad by hawala channel, and these return as official money to India as export sales, foreign investment, loans, etc. This is largely black money. Further there is no need for funds to return to the same location from where the same were sent. Nor is it necessary for the funds to return to the person or persons in the group who sent the funds.

Let us understand this through an example:

Mr. DS (resident of India) sets up DS Inc in Mauritius by investing ₹1 crore in the shares. Subsequently, DS Inc. invests and trades in the shares of companies listed in the stock market.

Will GAAR provisions apply where the jurisdiction of the Foreign Portfolio Investors (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

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.

2(b) Accommodating Party

An accommodating party is one which facilitates the transaction for the assessee in a tax efficient manner & the only purpose is to facilitate the tax efficient transaction. Therefore, it is provided that an arrangement with an accommodating party will be deemed to lack commercial substance if the main purpose of direct or
indirect participation of that party in an arrangement (whole or part) is to obtain a tax benefit for the assessee.

It is not necessary that the accommodating party is a connected party or not. If there is an accommodating party or a connected person, then such persons can be ignored and the transaction can be considered to have been undertaken by the assessee itself.

**Example:**
DS Ltd. exports goods to SS Inc. in Dubai. SS Inc. is owned by a Dubai resident (Mr. SS) who is not connected to Mr. DS. SS Inc. sells goods at a profit. The entire transactions are managed by Mr. DS. Then after a few years, SS Inc. gives a loan to DS Ltd. as an ECB. After 5 years, the loan is written off as DS Ltd. is making losses and cannot repay the loan.

Thus tax free profits made by DS Ltd. and parked with SS Inc., comes back as tax free loan. SS Inc. will be an accommodating party. The accommodating party can be disregarded and DS Ltd. can be considered as the assessee for the entire transactions under GAAR.
Transaction which disguises the value, location, source, ownership or control of funds

(i) X Ltd. is a banking institution in Mauritius-LTJ (Low Tax Jurisdiction);

(ii) There is a closely held company SS Inc in LTJ which is a wholly owned subsidiary of another closely held Indian company DS Ltd.

(iii) SS Inc has reserves and, if it provides a loan to DS Ltd., it may be treated as deemed dividend under section 2(22)(e) of the Act.

(iv) Therefore, SS Inc makes a term deposit with X bank Ltd. and X bank Ltd., on the basis of this security, provides a back to back loan to DS Ltd.

Say, India-Mauritius tax treaty provides that interest payment to a Mauritian banking company is not taxable in India.

Can GAAR be invoked?

YES

1. This is an arrangement whose main purpose is to bring money out of reserves in SS Inc. to India without payment of due taxes.
2. The tax benefit is saving of taxes on income to be received from SS Inc. by way of dividend or deemed dividend.
3. The arrangement disguises the source of funds by routing it through X bank Ltd. X bank Ltd. may also be treated as an accommodating party. Hence, the arrangement shall be deemed to lack commercial substance.
4. Consequently, in the case of DS Ltd., the loan amount would be treated as dividend income received from SS Inc to the extent reserves are available with SS Inc. and no expense by way of interest would be allowed.
5. In the case of X bank Ltd., exemption from tax on interest under the DTAA may not be allowed as X Ltd. is not a beneficial owner of the interest, provided the DTAA has anti-avoidance rule of beneficial ownership.
6. If such anti-avoidance rule is absent in DTAA, then GAAR may be invoked to deny treaty benefit as arrangement will be perceived as an attempt to hide the source of funds of SS Inc.
Example:

A Discretionary Trust in UK has UK professional trustees. It invests in India and gets relief under the India-UK DTA. The trust is actually controlled by the Hong Kong resident and he is the beneficiary of the trust income. The owner is being disguised. This transaction will be considered as tainted.

THE Location of an asset or of a transaction or of the place of residence of any party is without any substantial commercial purpose other than obtaining a tax benefit

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

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

(iii) A Ltd. is a company incorporated in Mauritius 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-Mauritius tax treaty provides for non-taxation of capital gains in the source country and Mauritius 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.

YES

1. The arrangement of routing investment through Mauritius results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in Mauritius which is a Low Tax Jurisdiction (LTJ), it can be said that the main purpose of the arrangement is to obtain a tax benefit.

2. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd.

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

4. 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 existence of a tainted element are satisfied, GAAR may be invoked.
(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 Mauritius, capital gains arising to A Ltd. are not taxable in India.

Will GAAR apply?

Illustration - Mr. A is an Indian resident. He is expecting substantial gain from sale of his foreign assets. He becomes a non-resident, sells the foreign assets, and then returns to India. Here residence of Mr. A is involved. If there is no commercial purpose for Mr. A to become a non-resident, it will be considered as a tainted transaction.

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<td>No CG u/s 45</td>
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<tr>
<td>SS Ltd. (Listed Co)</td>
<td>Partnership Firm</td>
</tr>
<tr>
<td></td>
<td>Sells shares</td>
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<tr>
<td></td>
<td>LTCG – Exempt u/s 10(38)</td>
</tr>
<tr>
<td></td>
<td>No MAT</td>
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</table>

Facts:
1. If DS Ltd. had itself made an investment of `1 crore in shares of a SS Ltd. (a listed company) on 1st January, 2020.
2. After a year, the prices go up and fair market value of shares becomes `11 crore.
3. If DS Ltd sells these shares, the long term capital gains of `10 crores would be exempt but it would be liable to tax under MAT@ the applicable rate.
4. Therefore, DS Ltd. forms a partnership firm with another person with nominal partnership.

Interpretation:
1. The only purpose of forming a partnership and transferring assets to such firm and selling the shares is to save tax arising out of MAT liability of DS Ltd.
2. Further, there is no commercial substance in the formation of the partnership as it does alter the economic position of DS Ltd in terms of business risks or cash flow.
5. It transfers its shares in the firm at a cost price. No capital gain arises as per section 45 of the Act.
6. After a year, the firm sells these shares and realises the gains of `10 crore which is exempt from taxation and no MAT is payable.
7. Subsequently, the firm is dissolved and share of DS Ltd in the partnership firm is transferred back along with profits, which is exempt from tax under the Act.
8. STT is paid both at the time of purchase as well as sale.

Can GAAR be invoked in this case?

3. Moreover, the entire exercise is carried out in an abnormal manner.
4. Even holding of shares by the partnership firm for a year or more is no significant economic risk to the company.

Hence, GAAR may be invoked and the partnership firm may be disregarded and capital gains may be subject to MAT in the hands of DS Ltd.

**DS Comment:** GAAR & SAAR can Co-exist albeit on different person in respect of impermissible arrangement. (Double Whammy!!)

1. GAAR in the hands of the company: As discussed above.
2. SAAR in the hands of the firm: Since the shares were acquired by the firm through the company and not from the recognized stock exchange, the exemption, u/s 10(38) shall not be available to the firm and the LTCG shall be taxable in its hands.

Further as per the CBDT notification u/s 10(38) no exemption shall be available under this section, interalia, in respect of the shares obtained through private placements.

**Clarification of CBDT on GAAR**

CBDT has clarified that

1. Threshold of `3 crores in respect of tax benefit in a relevant assessment year arising in aggregate to all parties to the arrangement.
2. GAAR not to apply to Foreign Institutional Investors (“FII”) subject to satisfaction of certain conditions.
3. As per the new GAAR notification by CBDT, the investments made before 1st April 2017 will be grandfathered.
4. 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.
<table>
<thead>
<tr>
<th>Question</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>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?</td>
<td>CBDT has clarified that if the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow</td>
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<tr>
<td>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.</td>
<td>CBDT has clarified that 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.</td>
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<tr>
<td>Tax benefit of INR 3 crores 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).</td>
<td>CBDT has clarified that 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 `3 crores cannot be read in respect of a single taxpayer only.</td>
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<td>Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?</td>
<td>CBDT has clarified that 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.</td>
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<td>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 sets-off losses</td>
<td>CBDT has clarified that 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.</td>
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<tr>
<td>Question</td>
<td>Answer</td>
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<td>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 CurrencyConvertible 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?</td>
<td>Grandfathering 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. However, 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.</td>
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<tr>
<td>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.?</td>
<td>Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.</td>
</tr>
<tr>
<td>Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?</td>
<td>No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.</td>
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<tr>
<td>No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.</td>
<td>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.</td>
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</table>
Chapter 17

**Assessment Procedure for GAAR Invocation**

### Section 144BA

If at any stage of Assessment or Reassessment Proceedings AO, on the basis of material & evidence available considers necessary to make a reference to PCIT/CIT to declare IAA & determine its consequences

The PCIT/CIT may issue notice to assessee for submitting objections and providing an opportunity of being heard within a period not exceeding 60 days.

- **No Objection filed by Assessee:**
  - PCIT/CIT to issue directions to AO to declare IAA
  - AO to complete assessment proceedings in accordance with such directions and provisions of GAAR.

- **Objection filed by Assessee:**
  - PCIT/CIT is not satisfied with the explanation.
    - PCIT/CIT to make reference to Approving Panel (AP) & Record satisfaction of applicability.
    - AP may give an opportunity of being heard to assessee & AO.
    - AP may direct PCIT/CIT to make further inquiry and furnish report.
    - AP may call for & examine records.
    - AP may require assessee to furnish documents & evidences.
  - PCIT/CIT is satisfied with the explanation.
    - PCIT/CIT to communicate the same to the AO by order in writing with a copy to the assessee
    - AO to complete assessment without invoking GAAR.

Prior approval of the PCIT/CIT required for passing assessment order, if any tax consequences have been determined in the order as per the provisions of GAAR.

No appeal shall lie against such directions.

Directions binding on the assessee, PCIT/CIT and subordinate IT.
The following period has to be excluded in computing the said period:

(i) The period commencing from the date on which the first direction is issued by the Approving Panel to the Principal Commissioner or the Commissioner for getting inquiries conducted through the authority competent under an agreement referred to in section 90 or section 90A and ending with the date on which the information so requested is last received by the Approving Panel or one year, whichever is less.

(ii) The period during which the proceeding of the Approving Panel is stayed by an order or injunction of any court.

**Note** – If, immediately after the exclusion of the aforesaid time or period, the period available to the Approving Panel for issue of directions is less than 60 days, such remaining period shall be extended to 60 days. Consequently, the aforesaid period of six months shall be deemed to have been extended accordingly.

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### Approving Panel

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Provisions</th>
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<tbody>
<tr>
<td>(1) Constitution</td>
<td>The Central Government may constitute one or more Approving Panels as may be necessary</td>
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<tr>
<td>(2) Composition</td>
<td>Each Approving Panel may consist of three members including a Chairperson</td>
</tr>
<tr>
<td>(3) Qualification of members</td>
<td>(i) The Chairman shall be a person who has been a judge of a High Court</td>
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<td>(ii) One member shall be a member of IRS not below the rank of PCC/CCIT</td>
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<td>(iii) One member shall be an academic or scholar having special knowledge of matters, such as direct taxes, business accounts and international trade practices.</td>
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<td>(4) Term</td>
<td>Ordinarily for one year; May be extended from time to time upto a period of three years.</td>
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<tr>
<td>(5) Frequency of Meeting</td>
<td>The Chairperson and members of the Approving Panel shall meet, as and when required, to consider the references made to the Panel. They shall be paid the remuneration as may be prescribed.</td>
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<tr>
<td>(6) Powers</td>
<td>(i) The Approving Panel has to issue such directions, as it deems fit, in respect of declaration of the arrangement as an impermissible avoidance arrangement in accordance with the provisions of Chapter X-A including specifying the previous year or years to which such declaration of an arrangement as an impermissible avoidance arrangement shall apply.</td>
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<td>(ii) The Approving Panel, may, before issuing any direction under section 144BA(6), if it is of the opinion that any further inquiry in the matter is necessary, direct the PC/C to make such inquiry or cause the inquiry to be made by any other IT authority and furnish a report containing the result of such inquiry to it.</td>
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<td>(iii) Call for and examine such records relating to the matter as it deems fit.</td>
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</table>
(iv) Require the assessee to furnish such documents and evidence as it may direct
(v) All the powers which are the vested in the AAR u/s 245U

(7) Officers
The CBDT shall provide to the Approving Panel such officials as may be necessary for the efficient exercise of powers and discharge of functions of the Approving Panel under the Income-tax Act, 1961.

(8) Rules
The CBDT may make rules for the purpose of the constitution and efficient functioning of the Approving Panel and expeditious disposal of the references received.

Question 1
a) An Indian company, X Ltd., is a closely held company and it is a subsidiary of company Y Ltd. incorporated in country C1. X Ltd. was regularly distributing dividends but stopped distributing dividends from 1.4.2003, the date when dividend distribution tax was introduced in India. X Ltd. allowed its reserves to grow by not paying out dividends. As a result, no DDT was paid by the company. Subsequently, buyback of shares was offered by X Ltd. to its shareholder company Y Ltd. Y Ltd. paid taxes on the capital gains arising on buyback of shares at the applicable rate. Can GAAR be invoked on the ground that there is a deferral of tax liability by X Ltd., the Indian company?

b) In the above case (a), let us presume, there is a DTAA between India and Country C1 which provides that capital gains arising in India to a resident of country C1 shall not be taxed in India provided that the resident incurs $200,000 annually as operating expenditure. The shareholder Y Ltd. incurs an operating expenditure above that limit and is entitled to the treaty benefit. Y Ltd. therefore does not pay any tax on capital gains.
Can GAAR be invoked on the ground that accumulation of profits by company X Ltd. and subsequent buyback is an arrangement mainly to obtain tax benefit?

Solution
a) Whether to pay dividend to its shareholder, or buy back its shares or issue bonus shares out of the accumulated reserves is a business choice of a company. Further, at what point of time a company makes such a choice is its strategic policy decision. Such decisions cannot be questioned under GAAR.

b) Payment of dividend to its shareholder or buy back of its shares or issuing bonus shares out of the accumulated reserves is a business choice of a company, which a company is entitled to exercise at any point of time. It should be interpreted as incidental that the shareholder is entitled to a treaty benefit which exempts capital gains, but it is subject to SAAR (i.e. Limitation of Benefit clause). The decision of X Ltd. cannot be questioned under GAAR.
Question 2

Company X borrowed money from Company Y and used it to buy shares in three 100% subsidiary companies of X. Though the fair market value per share was `100, X paid `600. The amount received by the said subsidiary companies was transferred back to another company connected to Y. The said shares were sold by X for `100/ each and a short-term capital loss was claimed. This was set off against short-term capital gains from other sources. All the companies are Indian companies. Can GAAR be invoked?

Solution

By the above arrangement, the tax payer has obtained a tax benefit and created rights or obligations which are not ordinarily created between persons dealing at arm’s length. Since transactions of purchase and sale of shares of a closely held company at a price other than the fair market value are covered under section 56 of the Act, GAAR may not be invoked as section 56, being SAAR, is applicable. However, if SAAR is not applicable considering the limited scope of section 56 to the shares of closely held companies only, then GAAR may be invoked.

Question 3

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.

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?

Solution

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.
**DS Inc. resident of Netherlands, has 2 WOS – SS1 Inc. & SS2 Inc. Both SS1 Inc. & SS2 Inc. holds 9.95% in XY Ltd. an Indian company. Later SS1 Inc & SS2 Inc sold shares of XY Ltd. to a third party in India.**

**Chapter 17: General Anti Avoidance (GAAR)**

**Question 4**

**Transaction:**
India-Netherlands DTAA provides that, any capital gains arising from the sale of shares of XY Ltd, an Indian company would be taxable only in Netherlands if the transferor is a resident of Netherlands and does not holds more than 10% interest in the capital stock of XY Ltd. DS Inc. being resident in Netherlands, has made an investment in XY Ltd. through two wholly owned subsidiaries (SS1 Inc. & SS2 Inc.) located in Netherlands. Each subsidiary holds 9.95% shareholding in the Indian Co, the total adding to 19.9% of equity of XY Ltd. The subsidiaries sell the shares of XY Ltd. and claim exemption as each is holding less than 10% equity shares in the Indian company.

**YES.**

a) The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty.

b) Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor DS Inc. and reveals a tainted element of abuse of tax laws.

c) Hence, the arrangement would be treated as an impermissible avoidance arrangement by invoking GAAR.

d) Consequently, treaty benefit would be denied by ignoring SS1 and SS2, or by treating them as one and the same company for tax computation purposes.