

Applicability of GAAR – Fundamental requirements

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1. Preamble:

General Anti-Avoidance Rule (GAAR) is effective from 1.4.2017 (Assessment Year 2018-19). It is meant to apply to transactions which are prima facie legal, but result in tax reduction. Broadly, tax reduction can be divided into 3 categories. One is tax mitigation which involves legal measures with substance to save taxes (e.g. setting up a new unit in SEZ). This is acceptable even after GAAR has come into force. Second is tax evasion where the transactions are outright sham, or are concealed. This is not covered by GAAR as existing jurisprudence is sufficient to cover tax evasion / sham transactions. The third is 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. This kind of tax avoidance planning are sought to be covered by GAAR.

With GAAR, there is no difference between tax evasion and tax avoidance. All transactions which have implications for avoiding income-tax, can be under the scanner of GAAR. At the same time all tax saving transactions cannot be considered under GAAR. A tax relief provided by the Government cannot be a matter of GAAR scrutiny if the relief has been claimed in a bona fide manner and as per rules.

The focus of this article is on fundamental requirements which have to be satisfied for GAAR to apply. There are some exemptions provided from applicability of GAAR. There are issues on applicability of GAAR when SAAR is present or when a DTA is available. Those provisions have been dealt with in separate articles by other authors. Implications if GAAR applies, dispute resolution mechanism and other issues concerning GAAR are also dealt with by other authors in other articles.

Abbreviations used

AO	-	Assessing Officer
GAAR	-	General Anti-Avoidance Rule
IAA	-	Impermissible Avoidance Arrangement
ITA	-	Income-tax Act
R	-	Rule
S / Ss	-	Section / Sections

2. When can GAAR apply?

- 2.1 Section 95 deals with the basic requirement for applicability. It applies to an arrangement if it is declared as an impermissible avoidance arrangement (IAA). Arrangement is discussed in paras 2.2.1 to 2.2.3. IAA is discussed in paras 4 to 6.

The section begins with a non-obstante clause - "Notwithstanding anything contained in the Act ...". Thus GAAR has an overriding applicability.

There are several non-obstante clauses in the ITA. Some are restrictive and some are exhaustive. For example, S. 94B provides that notwithstanding anything contained in this act, interest paid to an Associate Enterprise and exceeding 30% of EBITDA will be disallowed under specified circumstances. Will S. 94B override GAAR or will it be the other way? Both provisions continue to apply simultaneously. Prima facie, there will be a disallowance of interest u/s. 94B to some extent. This is mandatory. Intention of tax avoidance does not have to be considered. However, if it is determined that the arrangement is IAA, then GAAR can be invoked. If GAAR is invoked, the entire interest may be disallowed (depending on the circumstances). Thus, GAAR can go beyond other sections.

S. 206AA provides that if the recipient of income does not provide PAN to the payer, then higher of the specified TDS rates will be applied - notwithstanding anything contained in the ITA. Here, there is no conflict as such between S. 206AA and GAAR. S. 206AA applies to the payer. GAAR applies to income earner. Hence both the sections can apply simultaneously.

By and large GAAR will have an overarching applicability.

The explanation to section 95 clarifies that the provisions of GAAR chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement. Thus, scope of applicability is very wide.

2.2.1 **Arrangement** - S. 102(1) defines an "arrangement" to mean:

- 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.

It includes a singular transaction, or multiple transactions which can amount to an operation or a scheme or an agreement or an understanding. It also includes a step in or a part of a transaction.

The arrangement may be enforceable or not. For example, a scheme of illegal betting is not enforceable. However, GAAR can apply.

To avoid any controversy, it has been stated that alienation of any property in an arrangement can also be considered as an arrangement.

2.2.2 A part of the arrangement or a step in it is also considered as an arrangement. There is an issue as to whether GAAR will apply only to that part which is IAA, or the whole. Rule 10UA clarifies that where only a part of arrangement is IAA, GAAR will apply only to that part. There is no clarification in case only a step in the arrangement is considered as IAA. However a step would mean a part of the arrangement. Logically GAAR should apply only to the step in the arrangement which is held as IAA.

Step has been defined in S. 102(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. The emphasis is on a step in a series. Can a single step by itself mean that it is an arrangement? It appears that if it is a part of series of transactions, then it can be considered as a part of arrangement.

2.2.3 Even a single transaction can also be considered as an arrangement. It is difficult to envisage a transaction as an arrangement. For example, if a person gives a gift of his property to a non-resident, by itself it is a transaction. The donor will not earn any income after the gift. This cannot be considered as an arrangement. However in future, the non-resident returns the sum to the donor with the income which he earned outside India (without paying tax in India). Can it be treated as IAA? If it can be established that the transfer of funds abroad was with the pre-determined understanding that the funds will come back to India, it can be considered as an arrangement. Here the arrangement will include all transactions from giving the gift till returning the money. But only one transaction of gift cannot be considered as an arrangement.

However, consider a transaction of a non-resident. Before returning to India, he gifts his funds to an offshore company. The income will be earned by the offshore company. Will this one transaction be considered as an IAA? Perhaps yes. There is another view that GAAR cannot apply to a non-resident. However, in my humble submission, there is no restriction that GAAR cannot apply to arrangements entered into by non-residents if the intention is to avoid Indian tax. R. 10U(2) clarifies that GAAR can apply irrespective of the year in which the arrangement was entered into.

2.3 GAAR will apply in accordance will the guidelines and subject to the conditions as may be prescribed. Rules 10U, 10UA, 10UB and 10UC lay down the guidelines and conditions.

3. **Onus on whom?**

3.1 Under GAAR the onus is on the revenue to declare an arrangement as IAA. The declaration of an arrangement as an IAA has to be under a specified process u/s. 144BA read with the relevant rules. If the revenue considers that

the arrangement is an IAA, the assessee will be given an opportunity to be heard. Based on the response of the assessee further action will be taken

Thus there is no suo-moto application of GAAR. It is has to be specifically applied by the revenue by declaring the arrangement as IAA.

Having declared an arrangement as IAA, the onus shifts to the assessee to rebut the declaration or agree with the revenue's view.

This is one of the important differences between GAAR and Specific Anti-Avoidance Rule (SAAR). The SAAR lays down specific rules which have to be complied with in order to obtain the relief / or for tax not to apply. The onus is primarily on the assessee to comply with the rules.

- 3.2 There is a however a presumption regarding the onus on the assessee. If a step in or a part of arrangement is for the main purpose of obtaining tax benefit, then it will be presumed that the entire arrangement is for obtaining tax benefit. This is the presumption even though the main purpose of the whole arrangement was not to obtain tax benefit. [S. 96(2)]. The assessee can then prove that the main purpose of the entire arrangement was not to obtain tax benefit.

This rebuttal by the assessee will be required if the revenue declares the arrangement to be an IAA.

4. **Impermissible Avoidance Arrangement (IAA):**

The key test for GAAR to apply is IAA. Section 96 defines IAA. Two conditions have to be satisfied together to consider an arrangement as IAA.

- A) One is that there is a tax benefit. (This should be the main purpose.)
- B) Secondly, any of the four situations occur (or don't occur). (These are also known as tainted element tests.)
- i) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length.
 - ii) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act.
 - iii) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part.
 - iv) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

In clause B) above, the tests are not cumulative. These are alternative tests. Each of the above clauses has vast scope. Let us see below the important terms.

5.1 Tax benefit:

5.1.1 Tax benefit has been defined in Section 102(10). R. 10U(3)(iv) further clarifies the meaning. It is an inclusive definition and includes:

i) reduction or avoidance or deferral of tax or other amount payable under the ITA - whether due to a DTA or otherwise.

Tax has been defined u/s. 2(43) to mean income-tax chargeable under the provisions of this Act. (There is a reference to super tax and Fringe Benefit tax which are currently not relevant.)

However what will be included in "other amount"? Will it include surcharge, education cess, interest and penalty? In my view interest and penalty cannot be included in the meaning of tax. Interest and penalty are consequences of a delay in payment of tax, or an offence for avoiding tax. However interest, education cess and surcharge will be included in the phrase "other amount" as the character is that of tax.

ii) increase in refund or other amount payable under the ITA - whether due to DTA or otherwise.

iii) reduction in total income or increase in loss.

Thus benefit due to change in tax or change in income will be considered as tax benefit.

5.1.2 The tax benefit has to be considered in the relevant previous year or any other previous years. The "relevant" previous year is not explained but should mean the year when the arrangement is declared as IAA. However what is the significance of "any other previous years"?

Rule 10U(1)(a) has provided that if the tax benefit is Rs. 3 crores or less, then GAAR will not apply. CBDT has stated in its circular no. 7 dated 27.1.2017 in answer to question 14 that benefit has to be seen "assessment year specific". It means that if the benefit during the specific year is Rs. 3 crores or less, GAAR will not apply. Consider an illustration below.

A person enters into an IAA where the tax benefit is Rs. 1 cr. per year for 5 years, will GAAR apply? Section 102(10) provides that the benefit can be in the relevant previous year or any other previous years. Thus it would mean

that GAAR will apply as the tax benefit is Rs. 5 crores in the relevant previous year and any other previous years. However CBDT circular states that the benefit has to be seen assessment year specific.

- 5.1.3 Can one take a view that the limit of Rs. 3 cr. has to be considered when the arrangement is declared as IAA? Then the benefit may be in one year or spread over few previous years. In the above example, when the arrangement is declared as IAA, the tax benefit is determined at Rs. 5 cr. It is only spread over a few years. Hence GAAR will apply.

CBDT circular appears to be beneficial. The benefit has to be seen “assessment year specific”. In the above case as the benefit is Rs. 1 cr. GAAR should not apply.

- 5.1.4 Should the tax benefit be considered per assessee or spread across all assessees involved in the IAA? Section 96(1) refers to tax benefit in case of an arrangement. Whether one assessee benefits or several assessees benefit, is not relevant. CBDT also has clarified that the tax benefit cannot be restricted to one assessee. (Question 14).

However if an arrangement provides tax benefit to one assessee and excess tax to another assessee, excess tax for one person be reduced from tax benefit to another? The objective is to consider the tax benefit across all assessees. Hence if the net result is a tax benefit of less than Rs. 3 cr., GAAR should not apply.

On the same logic, if a person claims a loss in one year due to IAA, but will be paying tax in future years, can GAAR apply (as there is no tax benefit over the years)? Here the GAAR will apply as the there is a tax deferment.

- 5.1.5 How has the tax benefit to be computed? If an assessee has a specific arrangement and has paid tax of say Rs. 100. With what will this tax of Rs. 100 be compared with to arrive at the tax benefit?

The revenue will have to “re-arrange” the facts and arrive at re-worked 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.

For example, if instead of dividend, the company makes a buyback of shares. Tax under both arrangements is same or less than Rs. 3 crores, then obviously it will not be an IAA. However see para 11 for more discussion.

- 5.2 **Main purpose** – The previous versions of GAAR provided that the tax benefit should be the main purpose or one of the main purposes. The expert

committee appointed in 2012 recommended removal of reference to “one of the main purposes”. Thus tax benefit should be the main purpose of the IAA. If there are other main purposes and tax benefit is one of them, then GAAR will not apply.

The issue is how does one consider whether the tax benefit is the main purpose or only one of the purposes. There is a view which states that there is not much difference “main purpose” and “one of the main purposes”. Consider an illustration.

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 gain; 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.

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.

Consider another illustration where a UK MNC has subsidiaries in a few countries. For investment in India, it can invest from UK, or from a subsidiary in Singapore. While there is an office in Singapore, the staff is limited. Key business decisions are taken in UK. The main purpose of investment from Singapore is to take advantage of India-Singapore DTA which gives relief for Capital Gain tax. The decision for investment is also taken by the UK company. As the main purpose is to obtain tax benefit, GAAR can apply. (Of course GAAR will apply when the company earns income. On just investment, GAAR cannot apply.)

5.3 R. 10U(2) provides that GAAR will apply to any arrangement even if it is entered into prior to 1st April 2017 but the tax benefit is obtained on 1st April 2017 or later.

6. **Tainted elements:**

IAA refers to 4 tainted elements test. Out of these, “lacking commercial substance” test is the most important. Hence that is dealt with first in this article.

6.1 **Lacking commercial substance:**

6.1.1 **Lacking commercial substance - Section 96(1)(c) refers to arrangement which:**

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

“Commercial substance” has not been defined anywhere. “Lacking commercial substance” has been defined. Section 97 explains the meaning of “lacking commercial substance”. However it actually explains when will the arrangement be considered to be “deemed to lack commercial substance”. There is no meaning given specifically to lacking commercial substance.

Does one give importance to difference between “lacking commercial substance” and “deemed to lack commercial substance”? (This distinction is there under sections 5 (accrual of income) and 9 (deemed accrual of income) and has been explained by several courts.) Deemed accrual of income means the income actually may not accrue in India, but is deemed by fiction to accrue in India. Deeming provision has to be construed strictly. However the meaning of lacking commercial substance is so wide, that practically there may be no need to differentiate between the two. Lacking commercial substance and “deemed to lack commercial substance” would in effect mean one and the same thing.

An arrangement shall be considered to be deemed to lack commercial substance if any of the specified conditions are satisfied. I have divided the conditions into two groups as under:

6.1.2 **Conditions in which form appears more important than substance:**

- i) Effect of arrangement as a whole is different from individual steps or a part of arrangement.

The Supreme Court decision in McDowell (154 ITR 148) has referred to House of Lords decision of Ramsay. Ramsay decision states that there may be a series of steps which individually may be genuine but collectively it gives rise to avoidance of tax. Such an arrangement can be disregarded. The clause refers to such cases.

- ii) There is no significant effect on business risks or cash flows of party to an arrangement except for tax benefit.

Illustration - A promoter has two companies undertaking trading business in two different areas – say North India and South India. For some reasons, the company for North India earns profit and the company for South India incurs losses. To reduce taxes, the promoter books more sales for North India in the loss making company. Any shortfall in funds is met with temporary loan from the other company. Can this be considered as an arrangement where there is no effect on business risks or cash flows except for tax benefit? Unless the assessee can establish commercial reasons for the arrangement, GAAR may be applied.

Conditions which include certain actions:

iii) Round trip financing.

If an arrangement involves Round Tripping of funds, it will satisfy the tainted element test. Round trip finance has been explained in S.97(2). It includes an arrangement in which through a series of transactions:

- 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. Funds can come back as export sales, foreign investment, loans, etc. This is largely black money. Under FEMA, RBI has even considered round tripped ownership structure as Round tripping. Thus for example, if an Indian company invests in Mauritius company, and the Mauritius company invests in another Indian company, it is round tripping. This is so even if the funds which have been invested abroad, have been used for Mauritius business. These are not invested in India. The profits of Mauritius company are invested in India.

Under GAAR, round trip finance can apply even for tax paid disclosed transactions and not just black money.

Further there is no need for funds to return to the same location from where the same were sent. Nor it is necessary for the funds to return to the person or persons in the group who sent the funds. Simply a series of transactions amongst parties to an arrangement can be considered as round trip financing if the two tests are satisfied. The provision further clarifies that following circumstances are not relevant:

- 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. (The link of funds is not required. Beginning and end in the series is not relevant.)

- the time, or sequence, in which the funds involved in the round trip financing are transferred or received. (A systematic or timely movement of funds is not relevant).
- the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received. (How funds move is not relevant.)

This cannot be the objective but that is the language. The correct meaning should be that the funds return to the same place of the same person (or the group of the person is a part of). Then the “round” is complete.

“Series” has not been defined. The dictionary meaning is - a number of similar or related things... In my view, for GAAR, even two transactions will be considered as round tripping. Thus in the example of Mauritian investment, it will be considered as round tripping financing.

The key test is - does the series of transactions have commercial purpose? Commercial purpose has not been defined. One should take a common meaning. Practically it may be equated with commercial substance.

“Fund” has been explained in S. 102(5) to include cash, cash equivalents and right or an obligation to receive or pay cash or cash equivalent. It refers to liquid funds in form of cheques, negotiable instruments, etc. It does not include securities, mutual funds, etc.

Illustration - An Indian company invests abroad by exporting goods to the investee company. The foreign company invests in India by transfer of knowhow. Both these transactions are permitted under FEMA. Funds are not being remitted abroad or remitted to India. Legally this will not be round tripping. However one will be covered by other tainted element test - lack of commercial substance or abuse of law.

iv) Accommodating party.

If an arrangement involves an accommodating party, again tainted element test will be satisfied. S. 97(3) explains that an accommodating party will be considered as such 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 be have been undertaken by the assessee itself. It may be noted

that the implication of GAAR is on the assessee and not on the accommodating party or connected person.

Illustration – A Ltd. exports goods to X Ltd. in Dubai. X Ltd. is owned by a Dubai resident who is not connected to Mr. A. X Ltd. sells goods at a profit. The entire transactions are managed by A. Then after a few years, X Ltd. gives a loan to A Ltd. as an ECB. After 5 years, the loan is written off as A Ltd. is making losses and cannot repay the loan. Thus tax free profits made by A Ltd. and parked with X Ltd., comes back as tax free loan. X Ltd. will be an accommodating party. The accommodating party can be disregarded and A Ltd. can be considered as the assessee for the entire transactions.

“Connected person” is defined in S. 102(4). It is a very wide definition. The first limb itself states that it includes persons who are connected directly or indirectly. But in what manner? On what account? Due to which factor? And the definition states directly or indirectly. Relatives, etc. are included in the definition. The first phrase is simply without any connection to any tests!

Then it further states that connected persons include relatives, director of a company, partner of a firm, entity which has substantial interest by these persons or their relatives, etc. The definition is on the lines of S. 40A(2)(b) which deals with reasonableness of payment of expenditure to related persons.

“Relative” has been defined in S. 102(7) to mean persons defined in S. 56(2)(vi). It is a very broad list of relatives. One may note that it does not refer to the meaning of relative u/s. 2(41) which is a narrower definition.

“Substantial interest” has been defined in S. 102(8) to mean ownership of 20% or more in an entity. It is on the lines of the meaning in S. 40A(2)(b).

“Party” has been explained in S. 102(6) to include a person or a PE which participates or takes part in an arrangement.

v) Elements which have an effect offsetting or cancelling each other.

In an arrangement, where one transaction gives tax benefit, and the other transactions removes the effect of the first transaction, but the tax benefit continues to remain, it will be a tainted transaction.

Illustration – Co. A and Co. B have independent businesses. They decide to join together, merge their businesses, reduce competition and expand. However instead of establishing a new company, or merging, Co. A invests in share capital of Co. B to become 50% shareholder. Company B similarly invests in share capital of Co. A to become 50% shareholder. Both become 50% owner of combined business quickly without any tax implication. Can

these two investments in each other be considered as elements cancelling each other?

Illustration – A loss making company (say L) sells goods to a dealer, which dealer then sells it to a profitable group company of L, whether one can say purchase and sale transactions offset each other?

vi) Transaction through one or more persons which disguise the value, location, source, ownership or control of funds which is the subject matter of transaction.

Illustration – An investment banker has provided advice from Hong Kong to an Indian resident. There is no DTA between India and Hong Kong. The amount will be taxable in India as FTS. However the documents are arranged by the investment advisor as if it has been rendered from UK. Under the India-UK DTA, the amount is not taxable. This transaction will be considered as tainted.

Illustration – 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.

vii) 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 except obtaining a tax benefit.

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. See para 6.1.3.

6.1.3 An issue which arises is that whether commercial substance has to be considered for an arrangement or for an entity / person?

For example, if an Indian resident has business in India. He closes the Indian business and starts the business in the foreign company. The foreign company is being operated with proper office, people and resources. It is however controlled from India by Indian owners. The turnover of foreign company does not exceed Rs. 50 cr. and hence POEM guidelines do not apply. It is with substance. In this situation, should one see whether the arrangement has substance or the foreign company has substance?

The provision states that the arrangement should have commercial substance. Setting up a foreign company may have substance but the arrangement of transferring business abroad (whereby tax in India has been avoided) should have commercial substance.

This is one of the major differences issues under GAAR. Rearrangement of facts may not be sufficient to avoid GAAR if there is no commercial substance.

6.1.4 S. 97(4) provides that following factors shall be relevant but not sufficient to determine whether the arrangement lacks commercial substance:

- the period for which the arrangement exists.
- whether tax has been paid.
- whether exit route has been provided in the arrangement (exit can be by way of sale of investment, business, operations or activity).

In the previous version of GAAR, it was provided that the above factors were not relevant to consider whether an arrangement lacks commercial substance. As per Shome committee recommendation, the provision has been amended stating that the above factors will be relevant but not sufficient. Now the assessee can consider the above factors along with other factors to establish that there is a commercial substance.

Illustration – An investor from Netherlands had invested in India. He forms a Netherlands company for the purpose of investment. India-Netherlands has a beneficial DTA for capital gain where India cannot tax capital gain earned by a resident of Netherlands. After a few years, the promoter emigrates to UK but continues his investment in India through the Netherlands company.

In such a situation if the Netherlands company sells the shares of Indian company, it should be possible to establish that the investment was in India for many years. While that is not sufficient to establish that it has commercial substance, but the fact that investment was made while the promoter was a resident of Netherlands and he held the investment for several years before he migrated to UK, should be sufficient to establish that there was commercial substance.

6.2 **Arm's length dealing** – This test provides that if an arrangement creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length, this test will be satisfied. [S. 96(1)(a)].

See example in para 6.3 below.

- 6.3 **Misuse or abuse of provisions of this Act** – This test provides that if any provisions of this Act (i.e., Income-tax Act) are misused or abused, then this test will be satisfied. [S. 96(1)(b)].

For example, an Indian company purchases goods from a third party abroad at a price higher than the normal market price. As the parties are not Associated Enterprises, Transfer Pricing rules primarily do not apply. An SEZ unit of the Indian company sells goods to the third party at a price higher than the market price. Thus excess price paid by the Indian company (which results in excess expenditure), is received back in the SEZ unit (which is tax free income). This will be considered as abuse of law (SEZ unit relief). It can also be considered as creating rights or obligations which are not ordinarily created between persons dealing at Arm's length (buying and selling at prices higher than market price).

- 6.4 **Bona fide purpose** – This test provides that if an arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes, then the test is satisfied. [S. 96(1)(d)].

Illustration – A foreign company has an Indian subsidiary to which it outsources manufacturing work. All the material, process and knowhow are provided by the foreign company. The holding company pays third parties, charges for marketing expenses, sponsorship payments, etc. The arrangement provides that the subsidiaries will pay a certain share of these expenses to third parties (which the subsidiary does not need to). It will not be considered as an arrangement for bona fide purpose.

7. **GAAR as additional provisions:**

S. 100 provides that the GAAR chapter applies in addition to or in lieu of any other basis for determining tax liability. Thus apart from other provisions, GAAR can also apply. GAAR can also apply in lieu (instead of) any other provisions.

This means that even if the person falls within a specific provision (e.g. he has complied with the provisions of Section 10AA, if the AO considers that the income shown is in excess of what would otherwise be, he can invoke GAAR and deny the benefit. In other words he can invoke GAAR, and apply the provisions in lieu of section 10AA.

What does “in addition to” mean? Does it mean that the AO can apply regular provisions and also apply GAAR? This would mean double tax. That cannot be the intention. Without an express provision, no income can be taxed twice. If GAAR is applied, the purported transaction is ignored and the correct transaction as perceived by the revenue is applied (known as counterfactual).

Illustration – In an IAA, an Indian resident pays technical service fees to a non-resident and deducts tax @ 10%. Under GAAR, the expense is disallowed. The payer is charged to tax @ 30%. Will the non-resident payee get refund of tax? There is no provision for corresponding adjustment. Here one can say GAAR applies in addition to other provisions. Thus what has been paid as TDS remains. Plus GAAR will apply to the Indian resident and normal tax will be levied. CBDT has clarified in its circular (question 13) that corresponding adjustment in another person's hands will not be made. GAAR is an anti-avoidance measure and adjustment across different tax payers will go against the deterrence.

However in case of the same assessee, if the transaction is recharacterised, then tax will be levied as per recharacterised transaction. If any excess tax has been paid by the assessee under IAA, the same will be considered under re-characterised transaction. (GAAR applies to neutralise tax benefit. It is not to levy tax again.)

GAAR will apply in addition to SAAR

8. Does GAAR seek to tax income where there is no taxable income?

Let us consider a few illustrations:

i) A person acquires shares at a value which is equal to the fair value u/s. 56(2) read with relevant rules (say Rs. 50). The true fair value value is Rs. 75. On purchase of shares at a low price, there is no income. Section 56 has deemed that if the purchase price is less than the specified fair value, the difference will be income. Section 56 is a deeming fiction. Can the AO allege that there is an income of Rs. 25 per share for the buyer? It is assumed that there is no cash dealing over and above the transaction price.

Section 56 is a Special Anti-Avoidance Rule (SAAR). It is true that GAAR can apply even if there is a SAAR. However on purchase, there is no income which can be taxed under the ITA. GAAR cannot presume any income, where there is none.

ii) An MNC has operating subsidiaries in Singapore and Indonesia. The Indonesian company is in the business of mining coal. The main activities happen in Indonesia. The Singapore company does billing for the entire MNC group. After collecting funds, it transfers the same to the operating companies and keeps a small margin for itself. It acts as the central point for the MNC billing. An Indian customer purchases coal from the MNC. The MNC delivers goods from Indonesia to the Indian buyer. The billing is however undertaken from the Singapore subsidiary. As the MNC does not have a PE in India, no income is taxed in India.

The MNC finds that the Indian market is growing and therefore it needs to set up a subsidiary in India. It invests in the Indian subsidiary from the Singapore company.

In this situation, GAAR cannot be applied on sales by the MNC just because the sales are from a company in a low tax jurisdiction. This is because even if it is assumed that Indonesian company is the real person selling the coal, the income would have been exempt in absence of a PE in India.

However when the investment is made from the Singapore company, the company will have to substantiate that the investment has not been made to avoid tax.

iii) Co. A borrows from its parent company abroad. Due to long gestation period of business, there are losses in the Indian company. Consequently, the parent writes off the loan. A write off of loan is a capital receipt and not income. Under GAAR, it is not possible to deem such a write off as receipt of sum without consideration liable to tax u/s. 56(2).

iv) An Indian resident is required to pay compensation to a non-resident who is a UK resident. The non-resident asks the resident to pay compensation to its group company in Netherlands. Compensation is usually not taxable being a capital receipt. However just because the amount is paid in an offshore centre, GAAR cannot be applied as the compensation per se is not taxable.

9. GAAR and TDS:

Can GAAR apply to a payer for tax deduction at source? Prima facie GAAR applies to "tax benefit". Therefore whoever obtains a tax benefit, can be liable under GAAR.

To understand the issue further, one may divide the topic in two categories - i) one where payer has to bear the tax (and therefore gross it up), and ii) where the recipient has to bear the tax.

In the first situation, the payer can be liable under GAAR if he satisfies the test of IAA. Practically in case of third party dealings, it will be difficult for the payer to have an "arrangement" to save taxes. The recipient would not agree for it. Of course if the parties are related, then it may be easy to make an arrangement.

In the second situation, the payer would not like to take the responsibility for default in tax related to the recipient.

However let us consider the following illustrations:

Illustration – An Indian resident purchases shares of an Indian company from a Singapore company. For considering the relief under India-Singapore DTA, the payer will have to see that all the conditions are fulfilled – Singapore company has a TRC, it has incurred expenditure of S\$ 2,00,000, etc. If all these conditions are satisfied, tax need not be deducted at source.

Illustration – An Indian company has set up a UAE company and books business in the UAE company. When an Indian resident client approaches this company, he is directed to the UAE subsidiary. The UAE subsidiary has staff, office, etc. However the staff takes instructions from the Indian Head Office. The Place of Effective Management is in India. It may not satisfy the LOB clause of India-UAE DTA. The Indian client does not know this. In such a situation, what is the responsibility of the Indian payer? If the Indian payer takes due care and deals with the UAE staff, he may not be responsible for TDS default. If however he comes to know that the UAE operations are only to avoid taxes, then he should ask the UAE company to obtain a TDS certificate u/s. 197. If he does not deduct tax, then the Indian client can be responsible. This was the case in Vodafone where it was held responsible for non-deduction of tax at source. It was cautioned by the tax department before it paid consideration to Hutch that there could be a tax liability.

Therefore at the time of deduction of tax, payer has to carry out due diligence for the transaction to understand with whom is he dealing with.

10. **Payment of foreign tax:**

An Indian company has set up a Singapore company and books business there. It has POEM in India but not disclose it to the department. It does not pay tax in India but pays a tax of 10% in Singapore.

Later the department comes to know and applies GAAR. The department wants to levy full tax on the profits. The company claims that it has paid tax in Singapore and therefore the tax benefit in India after considering credit for Singapore tax is lower compared to what the department is alleging. Will it be correct?

Tax benefit has to be considered qua the Indian taxes. If the foreign company is an Indian resident, then it is liable to tax on its global income. If it has a proper PE in Singapore, then to that extent it can get credit for tax paid in Singapore. The balance tax payable in India can be considered as tax benefit. However just because tax has been paid in Singapore, it does not mean that it has to be considered as a deduction from the Indian tax.

Thus payment of tax abroad is not relevant by itself to consider the tax benefit in India.

11. CBDT circular no. 7 dated 27.1.2017:

CBDT has issued the above referred circular clarifying a few issues under GAAR. Following questions are relevant to this article.

11.1 Question 3 - Will GAAR interplay with the right of the tax payer to select or choose method of implementing a transaction?

CBDT states in the answer that GAAR will not interplay with the right of tax payer to select a method of implementing a transaction.

What does it mean? It means that if there are one or more bona fide ways of doing a transaction, then the tax payer can select the manner he wants. GAAR will not come in between. (CBDT has not said GAAR will not apply. However the meaning should be that GAAR will not apply.) 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. However both have different implications. In dividend, only funds are returned. In a buyback, the capital of a company is reduced. If it is a listed company, the liquidity in the market of the shares reduces. 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.

To take another illustration, if the person has an option of setting up a unit in domestic area and an SEZ, and it chooses the SEZ, it does not mean GAAR can apply. (If the person shifts his existing business to SEZ unit, then GAAR can apply.)

11.2 Question 4 - If an FPI is based in a tax friendly jurisdiction for non-tax commercial reasons, will GAAR apply?

CBDT states that the situation will be examined based on the twin tests of tax benefit and tainted element tests in S. 96. If there are non-tax commercial reasons and tax benefit is not the main purpose, GAAR will not apply.

Thus again, one needs to satisfy the commercial purpose test of any arrangement.

12. Summary:

The conditions and tests are very elaborate. Almost any situation which will have the effect of tax reduction, can be covered within GAAR. Therefore one must analyse the tax implication of any transaction very carefully before undertaking the same.