Deloitte.

General Anti-Avoidance Rules (GAAR)

India and International Experience

March 2017

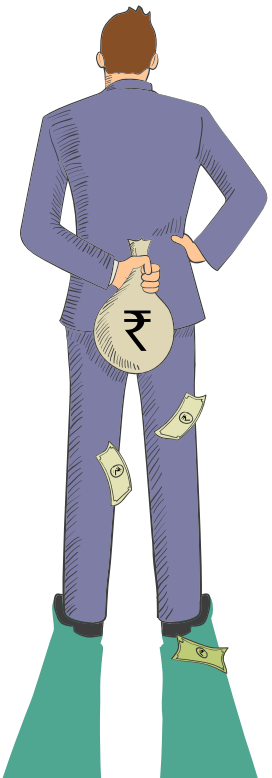
Introduction

Executive Summary

Internationally, tax avoidance has been recognized as an area of concern and several countries have expressed apprehension over tax evasion and avoidance. This is also evident from the fact that nations are either legislating the doctrine of General Anti-Avoidance Regulations in their tax code or strengthening their existing code. India has also sought to address the issues relating to tax avoidance and evasion by bringing in General Anti-Avoidance Rule (GAAR) in addition to various transaction-specific Special Anti-Avoidance provisions.

The introduction of GAAR recognizes that it may not always be feasible for the judiciary to address the unforeseen implications of transactions carried out for tax purposes and also the need to provide some semblance on the matter of tax avoidance.

However, given the inherent challenge and the subjective nature of the GAAR, if not appropriately implemented, it may affect business sentiment and deter foreign investors. Considering the goal of any anti-avoidance legislation, viz, targetted attack on tax avoidance arrangements without creating undue hardship for genuine and honest taxpayers, India would need to address the issue in the proper perspective so that the provisions and their implementation do not become a law onto themselves.



In formulating the GAAR, Indian tax authorities have followed an elaborate consultative process and have considered various concerns raised by the stakeholders in legislating the final regulations. This is a laudable effort. Although the CBDT has issued clarifications on certain issues raised by stakeholders, it would be helpful for taxpayers if the following are also considered:

- application of GAAR being explained by way of examples / illustrations;
- use of 'business-purpose test' with emphasis on the different concepts of the economic substance associated with the categories of tax avoidance behavior, such as tax evasion, acceptable tax avoidance and abusive tax avoidance; and
- balancing India's adoption of Base Erosion & Profit Shifting (BEPS) Action Plans of the Organisation for Economic Co-operation and Development (OECD) and application of GAAR.

This publication is an update to the earlier paper on the subject. It outlines some of the nuances relating to GAAR by examining the historical perspective for tax avoidance generally and in India. The concept of GAAR, international experience on GAAR legislation in some jurisdictions and GAAR provisions as incorporated under the Income tax Act, 1961 followed by a comparison with other countries have been covered in the paper. The earlier paper covered an overview of GAAR legislation in China, South Africa, Australia and Canada. The same has been updated in this paper to incorporate major developments in these jurisdictions since the last paper. This paper also gives an overview of GAAR legislation in UK, Germany, Singapore and Brazil and briefly discusses the ongoing BEPS action plan of the OECD to prevent treaty abuse and the steps taken by India to align the Indian tax law and treaties with the same. The way forward for authorities and the taxpayers has also been discussed.

Pre GAAR Concept

Internationally and in India, a constant debate has been raging over the issue of tax avoidance. Over the years, the term 'tax avoidance' is understood as arranging business affairs with the object of obtaining tax advantage while *prima facie* fully intending to comply with the law in such respect. Some principles underlying the meaning of 'tax avoidance' are:

- The expression is used to describe every attempt by legal means to prevent or reduce tax liability, which would otherwise be incurred, by taking advantage of some provision or lack of provision in the law. It pre-supposes the existence of alternatives, one of which would result in less tax than the other. Moreover, motive would be an essential element of tax avoidance. A person who adopts one of the several possible courses to save tax, must be distinguished from a taxpayer who adopts the same course for business or personal reasons[1].
- A course of action designed to conflict with or defeat the evident intention of Parliament[2].
- Where it reduces the incidence of tax borne by an individual taxpayer contrary to the intentions of Parliament[3].
- Tax planning may be legitimate, provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay their taxes honestly without resorting to subterfuges[4].
- Further, courts in India have broadly indicated that if some device has been used by a taxpayer to conceal the true nature of the transaction, it is the duty of the taxing authority to unravel the device and determine its true

[1] Carter Commission in Canada
[2] Lord Nolan in IRC v.Willoughby
[3] Lord Templeman
[4] Simon in Latilla v. I.R.C. (11 ITR Suppl. 78, 79) (HL)

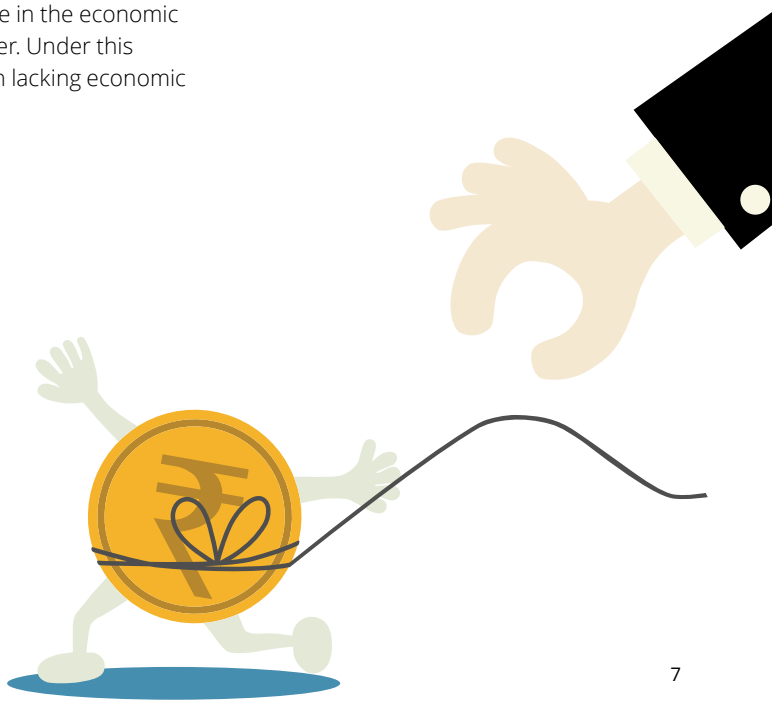
character. However, the legal effect of the transaction cannot be displaced by probing into the 'substance of the transaction'.

Considering these continuing difficulties of classifying transactions as being acceptable within the framework of law or not, a need is being felt to move towards a structured approach to address the issue of avoidance both from a legal and economic point.

In analysing the substance vs. form of a transaction, the question arises whether one needs to look at the legal or the economic substance.

'Legal substance' would refer to characterization which emerges from a close study of the rights and obligations in a legal relation, whereas 'economic substance' has different interpretations as propounded by various jurisdictions:

- 'Real economic substance' - This is the American notion under which the economic substance is determined by looking at both objective and subjective factors to see if there is any potential for profit other than tax savings, or if there is any meaningful change in the economic position of the taxpayer. Under this doctrine, a transaction lacking economic



substance will be ignored. In Gregory vs Helverig (1934) - US, the Court outlined that

"It does not follow that Congress meant to cover such a transaction. The meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. If what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was... [But] the purpose of the section is plain enough; men engaged in enterprises... might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as realizing any profit, because the collective interests still remained in solution.

In other words, the benefit of the objective tax result would be denied, where the transaction did not change the economic position, apart from the tax benefit, nor did it reflect any facet of the business, which could be considered as lacking economic substance, and was not "the thing which the statute intended".

- Step Transaction plus business purpose - This UK version combines step transactions doctrine and business purpose doctrine and enables the courts to overlook the step transactions that serve no business purpose. This could be evolved from the various juridical pronouncements made by the UK courts with regard to transaction considered as entered into with the objective of tax avoidance.

In Duke of Westminster vs IRC, their Lordships held that the Act is to receive a strict or literal interpretation and that a transaction is to be judged not by its economic or commercial substance but by its legal form. In Ramsay vs IRC, their Lordships watered down the economic substance theory on the ground that it could be invoked only when the purposive interpretation approach is adopted. The principle outlined herein came to be considered as a general rule of statutory construction, not a separate judicial doctrine.

The common denominator which can be found in most countries is that if a taxpayer has multiple avenues available to structure his transaction, he is free to choose the most tax-efficient avenue, provided a level of commercial justification for the same exists, and tax is not the only reason.

In respect of international recognition to the concept, the Vienna Convention provides that international agreements are to be interpreted in 'good faith'. In case any international agreement/treaty leads to unintended consequences like tax evasion or flow of benefits to unintended person, it is open to the signatory to take corrective steps to prevent abuse.

Further, the OECD leaves it to the individual countries to introduce anti-abuse legislation, which they consider, could be applied without interference by the Model Convention or the bi-lateral tax treaty between the countries *inter-se*. However, the OECD Commentary on Article 1 of the Model Tax Convention also clarifies that a general anti-abuse provision in the domestic law in the nature of 'substance over form rule' or 'economic substance rule' would not be in conflict with the treaty.

In other words, the general anti-abuse rule would override the provisions of the tax treaty. Hence, the underlying principle emanating from international experience in respect of tax avoidance and where GAAR legislation has not been enacted, is the recognition that the contentious issue of determining/ establishing the doctrine of substance over form would have to be established through an examination of the legal substance, the legal form, or the real economic substance of the transaction. This has also been duly adapted under Indian jurisprudence as outlined in the section below.

Pre GAAR Concept - India Experience

Indian tax laws, though providing for specific anti-avoidance measures, did not have any general anti avoidance rules or regulations. Courts in India have over the years drawn out the general parameters and principles in outlining whether a transaction or scheme would be considered as tax avoidance/tax evasion or tax planning under the tax laws.

The Hon'ble Supreme Court (SC)[5] observed that:

"...the law does not oblige a trader to make the maximum profit that he can get out of his trading transactions. Income which accrues to a trader is taxable in his hands. Income which he could have, but has not earned, is not made taxable as income accrued to him. Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in tax statutes may not, except on peril of penalty, be violated, but may lawfully be circumvented...."

[5] CIT v. A. Raman and Co. [1968] 67 ITR 11 (SC)

Further, in Bank of Chettinad's case[6], the Hon'ble Privy Council (PC) stated that:

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

Another important Indian case[7] addressing the substance over form question reiterated the principles laid down by the House of Lords in the decision of Duke of Westminster, and took the view that tax planning was legitimate so long as it was strictly within the four corners of the law and any 'colorable' device or dubious methods to minimize tax incidence were not legally permissible.

It appears that there is no single approach towards the issue of substance over form. A clear tendency exists for Revenue authorities to try and counter any kind of undesired outcome (in their eyes) of a certain piece of legislation, by applying the substance over form doctrine. However, while examining a legally valid transaction, the Revenue authorities should proceed objectively and not hypothetically attribute 'motives' behind the taxpayer's action.

We have witnessed a contentious journey for determining whether the affairs planned by the taxpayer were legitimate,

[6] Bank of Chettinad Ltd. v. CIT [1940] 8 ITR 522 (PC)
[7] McDowell and Co. Ltd. v. Commercial Tax Officer, [1985]154 ITR 148 (SC)

to be strictly within the four corners of the law or were part of a colorable device or dubious method entered into with a purpose to minimize tax incidence leading up to the decision[8] wherein the SC reiterated and continued to enshrine the principles as laid out in Duke of Westminster, as under:

"...With respect, therefore, we are unable to agree with the view that Duke of Westminster's case (1936) AC 1 (HL); 19 TC 490 is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster's case (1936) AC 1 (HL); 19 TC 490 is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah J. in CIT v. Raman, (1968) 67 ITR 11 (SC) are very much relevant even today..." and

"...It thus appears to us that not only is the principle in Duke of Westminster's case (1936) AC 1 (HL); 19 TC 490 alive and kicking in England, but it also seems to have acquired judicial benediction of the Constitutional Bench in India, notwithstanding the temporary turbulence created in the wake of McDowell's case (1985) 154 ITR 148 (SC)."

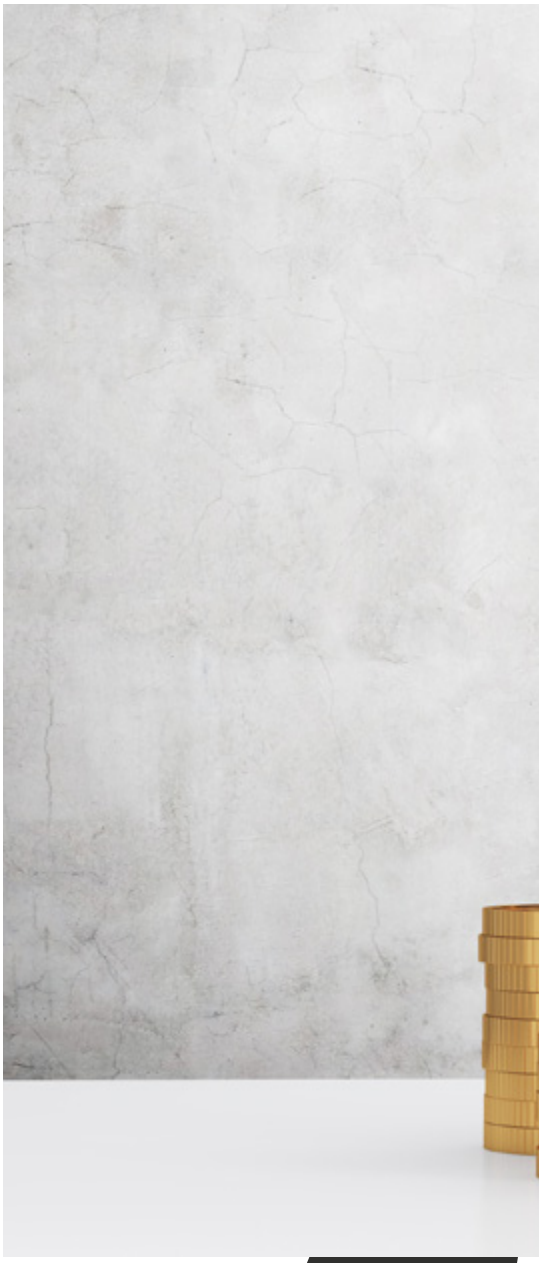
Further, the SC in Azadi Bachao Andolan's case observed that:

- the contention that the Double Taxation Avoidance Convention (DTAC) between India and Mauritius is *ultra vires*, is not acceptable — even if the DTAC is susceptible to 'treaty shopping' on behalf of the residents of third countries.
- a tax treaty or convention must be given a liberal interpretation. A holistic view has to be taken in this regard.
- An act, which is otherwise valid in law, cannot be treated as *non-est* merely on the basis of some underlying motive (supposedly resulting in some economic detriment or prejudice to the national interest, as perceived by the respondents).

However, the Revenue authorities have over the years challenged various forms of transactions entered into by taxpayers, specifically with regard to cross-border transactions.

The SC decision in the case of purchase of shares by Vodafone International Holdings B.V.[9], of a foreign company, which held directly/indirectly shares in an Indian company, is a landmark judgement, which paved way for several path breaking legislative changes, including introduction of GAAR in India. The SC observed that:

- The department's argument that there is a conflict between Azadi Bachao Andolan 263 ITR 706 (SC) & McDowell 154 ITR 148 (SC) and that Azadi Bachao is not good law, is not acceptable. While tax evasion through the use of colourable devices and by resorting to dubious methods and subterfuges is not permissible, it cannot be said that all tax planning is impermissible.
- The Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish that the transaction is a sham or tax avoidant (e.g. structures used for circular trading or round tripping or to pay bribes) or if the holding structure entity has no commercial or business substance and has been interposed only to avoid tax. A strategic foreign direct investment coming to India should be seen in a holistic manner and keeping in mind certain factors like the period of business operations in India etc.



[8] Union of India v. Azadi Bachao Andolan, [2003] 263 ITR 706 (SC)
[9] [2012] 341 ITR 1 (SC)

- It is a cornerstone of law that a tax payer is enabled to arrange his affairs so as to reduce the liability of tax and the fact that the motive for a transaction is to avoid tax does not invalidate it unless a particular enactment so provides. However, for the arrangement to be effective, it is essential that the transaction has some economic or commercial substance.
- For the principle of "fiscal nullity" to apply, there should be a pre-ordained series of transactions and there should be steps inserted that have no commercial purpose. In that case, the inserted steps can be disregarded for fiscal purpose and one can look at the end result.

However, it needs to be seen how the principles enshrined through judicial pronouncements (being principle-based or purposive) would continue to be followed under the Indian GAAR regime, wherein the distinction between tax avoidance and tax evasion is being sought to be obliterated.

BEPS and GAAR

In the last few years, international tax issues have been high on the political agenda due to the perception that various tax avoidance structures are being used by large multinational enterprises. The OECD has come out with 15 comprehensive Action Plans to counter BEPS caused due to weaknesses in the current international tax laws framework.

Action 6 (Prevent Treaty Abuse) report includes a minimum standard on preventing abuse including through treaty shopping and new rules that provide safeguards to prevent treaty abuse and offer a certain degree of flexibility regarding how to do so. It discusses a limitation on benefits (LOB) rule and a principal purposes test (PPT) rule. The minimum standard in this regard is to include in tax treaties:

i. The combined approach of an LOB and PPT rule;
ii. The PPT rule alone; or
iii. The LOB rule plus a mechanism to deal with conduit financing arrangements.

More targeted rules have been designed to address other forms of treaty abuse. Other changes provide for the reformulation of the title and preamble of the Model Tax Convention, which would clearly state that the intention of the parties to the tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular through treaty

shopping arrangements. The report further contains the policy considerations to be taken into account when entering into tax treaties with certain low or no-tax jurisdictions.

On 24 November 2016, the OECD released the widely-anticipated text of the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting (MLI). The MLI is designed to implement swiftly tax treaty-related measures arising from the BEPS project. It includes a number of minimum standards that jurisdictions signing up to the MLI are required to implement. The MLI supports all previously agreed BEPS approaches by allowing jurisdictions to select from alternative options, which they will do by filing "technical reservations." The MLI includes articles on PE, treaty abuse, dispute resolution and hybrid mismatches. Once the MLI is signed and it enters in to effect, the existing bilateral tax treaties of the countries signatory to the MLI would be modified by the MLI. Changes to the effect of double tax treaties will be prospective and are subject to jurisdictions both signing up to and ratifying the MLI.

The Indian GAAR overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules. A treaty override provision has been specifically included in certain recent bilateral tax treaties that India has entered into (e.g. India's tax treaties with Luxembourg and Malaysia) as well as in recent amendments to treaties such as with Singapore. The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as provided under the Indian GAAR. Currently, there is an anti-abuse rule in very few of India's tax treaties – UK, Luxembourg, Norway, Poland, Finland, UAE, Malaysia, etc. India has renegotiated some of its existing bilateral tax treaties, to combat treaty shopping by inserting anti-abuse rules, latest examples being the Protocol to India–Mauritius and India-Singapore tax treaties.

International Experience

In our earlier publication "General Anti-Avoidance Rules India and International perspective", we covered experience on GAAR legislation in select jurisdictions viz. Canada, Australia, China and South Africa. Since then, there have been further developments globally surrounding the GAAR. Judicial interpretation on GAAR has also evolved in various jurisdictions over a period of time. This publication contains an update to the GAAR regimes of jurisdictions covered by our earlier publication and also includes GAAR experience in UK, Germany, Singapore and Brazil.

Major highlights of the recent international developments on GAAR are as under:

- Extensive changes to the Australia GAAR provisions on account of legislation of Multinational Anti-Avoidance Law ('MAAL'). MAAL amends the existing GAAR and is applicable to income derived on or after 1 January 2016.
- Release of discussion draft of Special Tax Adjustment Implementation Measures for replacement of China's existing Circular No. 2 of 2009 which relates to transfer pricing guidance and includes GAAR provisions.
- Introduction of GAAR in UK in 2013 after completion of consultative process.

Australia

Background of legislation

Australia's GAAR was introduced in 1981 and is contained in Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936).

Part IVA was expanded with effect from 1 January 2016 to include the MAAL which deals with the avoidance of Permanent Establishment ('PE') status. It is also proposed to further expand Part IVA to include a Diverted Profits Tax ('DPT') from 1 July 2017. The MAAL and the DPT have been modelled on the UK DPT measures.

References below to the GAAR are a reference to Part IVA, other than the more specific provisions which deal with the MAAL and the DPT, whilst references to Part IVA cover all aspects of Part IVA including the MAAL and the DPT.

Part IVA is directed at schemes entered into for the purpose of obtaining "tax benefits". Part IVA supplements other SAARs.

Part IVA is generally a provision of last resort, i.e. it is generally only applied where positions adopted by a taxpayer satisfy the technical requirements of the Australian income tax legislation, including the ordinary provisions and SAARs, but when objectively viewed, are considered to be conducted or carried out with the relevant purpose of obtaining a tax benefit.

If certain conditions are met, the provisions allow the Commissioner to cancel all or part of any tax benefit which a taxpayer obtains from the scheme.

Under Australian domestic law, Part IVA takes priority over the terms of Australia's double tax treaties.

GAAR trigger event

The three key conditions which must be satisfied for the GAAR to apply are:

i. there must be a "scheme";
ii. there must be a "tax benefit" obtained in connection with the scheme; and
iii. the sole or dominant purpose of any person who entered into or carried out the scheme, or any part of it, must have been to enable the taxpayer to obtain that tax benefit.

The Commissioner of Taxation has the power to cancel the tax benefit arising from a scheme, as well as to impose interest and penalties. The determination of a tax benefit requires a comparison between the scheme (i.e., the transactions and the facts that actually took place) and an alternate scenario.

The following bases can demonstrate the existence of a tax benefit:

- Comparison of the tax consequences of the scheme with the tax consequences that "would have" resulted had the scheme not occurred, i.e. deletion of the scheme (the "annihilation approach"); or
- Comparison of the tax consequences of the scheme with the tax consequences that "might reasonably be expected to have" resulted if the scheme had not occurred, i.e. speculation of the state of affairs that reasonably would have occurred in the absence of the scheme (the "reconstruction approach").

Having identified the alternate scenario, there will be a tax benefit if for example:

- An amount not included in assessable income under the scheme would be included in assessable income under the alternate scenario;
- An amount claimed as a deduction under the scheme would not be deductible under the alternate scenario;
- An amount not subject to withholding tax under the scheme would be subject to withholding tax under the alternate scenario.

The maximum penalty on a Significant Global Entity ('SGE') (i.e. an entity belonging to an accounting group that has annual global income of AUD 1 billion or more) for tax avoidance arrangements and profit shifting schemes is up to 120% of the tax benefit if the taxpayer's position is not reasonably arguable.

MAAL

The MAAL provisions amend Part IVA, and are applicable to income derived on or after 1 January 2016. The MAAL counters arrangements that technically avoid PE status in Australia.

The MAAL can apply where both the "gateway tests" and "principal purpose test" are satisfied as follows:

- Gateway tests:
  - The multinational group has global gross income of AUD 1 billion or more (i.e. it is an SGE);
  - A foreign entity (the Principal) derives income from supply of goods or services (including by digital means) to an Australian customer that is not a member of the global group to which the Principal belongs;
  - An entity in Australia that is associated with or commercially dependent on the Principal undertakes activities in Australia directly in connection with the supply; and
  - Some or all of the income derived by the Principal from the supply is not attributable to an Australian PE of the Principal.
- Principal purpose test: This test would be met if, based on a number of factors, it is concluded that a principal purpose for entering into the relevant arrangements was to obtain:
  - An Australian "tax benefit" (as defined in Part IVA); or
  - An Australian "tax benefit" and to reduce or defer foreign tax liabilities.

In cases where the MAAL applies, the Australian Taxation Office ('ATO') could effectively deem a PE of the Principal in Australia. Any profit attributable to the deemed PE could be taxed at the general corporate tax rate of 30%. In addition, if the Principal pays any royalties/ interest amounts which could be attributable to the deemed PE, an Australian withholding tax liability on the upstream payments could arise. A potential penalty of up to 120% of the income tax and withholding tax liability could also be imposed.

DPT

A Bill was introduced into the Australian Parliament in February 2017 for the introduction of a DPT with effect from July 2017. It is to be inserted into Part IVA of the ITAA 1936.

As proposed, the DPT would apply to SGEs and would be levied at 40% (note that the general corporate tax rate is 30%) on profits transferred offshore through certain related party transactions.

Key features of the proposed DPT include the following:

- It would adopt a principal purpose test similar to that in the MAAL.
- The DPT could apply where (broadly) the associated foreign tax liability is less than 24% of the Australian tax benefit.
- Like the GAAR and the MAAL, the DPT operates in respect of a "tax benefit", as defined in Part IVA, thus requiring the ATO to identify an alternate scenario (based on Part IVA principles).
- As an exception, the DPT will not apply where the profits attributable to each entity in the scheme reasonably reflect the economic substance of the entity's activities.
- The DPT would be subject to an accelerated assessment process and more limited appeal rights, compared with normal income tax assessment procedures.

Brazil

Background of the legislation

In January 2001, general anti-avoidance rules were introduced through Supplementary Law 104 as a paragraph to Article 116 of the Brazilian National Tax Code. It stated that the administrative authority may disregard acts or legal transactions practiced for the purpose of concealing the occurrence of the event generating the tax or the nature of the constituent elements of the tax obligation, subject to the procedures to be established in ordinary law.

Based on this para, Brazilian tax authorities are allowed to disregard the formal aspects of a transaction and analyse only its economic substance for taxation purposes (substance over form). This rule still lacks further regulation and, therefore, could not be enforceable in theory.

However, Brazilian Tax Authorities have already been using Article 116 as a way to assess taxpayers using the substance over form concept. This issue has been discussed at Brazilian administrative tax court, on a case-to-case basis.

Trigger Event

Under the general anti-avoidance rules, any amount paid, credited, delivered, used or remitted directly or indirectly to an entity or individual incorporated or resident in a tax haven jurisdiction or benefiting from a preferential tax regime may be deducted only if the taxpayer can identify the beneficial "recipient" of the proceeds; provide proof that the entity or individual has the operational capacity to carry out the transaction for which the payment is made; and submit documentation showing the purchase price paid and the receipt of the goods, rights or the use of services.

SAARs

Apart from GAAR, the following anti-avoidance rules apply in Brazil:

- Transfer pricing
- Thin capitalization
- CFCs
- Disclosure requirements

Canada

A taxpayer is entitled to structure affairs so as to minimize tax within the confines of the law. However, tax planning (or tax minimization) must be contrasted with tax evasion, which may render the taxpayer liable to fines or imprisonment. Some forms of tax planning are restricted through the use of specific anti-avoidance provisions. What is considered to be more generally abusive planning is checked through a statutory GAAR.

Background

Canadian federal tax laws have contained GAAR provisions since 1988. Explanatory notes issued by the federal Department of Finance in 1988 stated that the rule:

"... .is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs..."

GAAR is a far-reaching provision that operates in addition to the many specific anti-avoidance provisions contained in the tax legislation. Where GAAR is applicable, the tax consequences of a transaction will be determined, as is reasonable in the circumstances, to deny the tax benefit that otherwise would result.

Three requirements must be established in order to permit the application of GAAR:

1. A tax benefit must have resulted from a transaction;
2. The transaction must be considered to be an avoidance transaction, in the sense that it cannot be said to have been reasonably undertaken primarily for a *bona fide* purpose other than to obtain a tax benefit;
3. The avoidance transaction must be considered abusive, in the sense that, it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer or the tax statute as a whole.

GAAR applies in a domestic and international context, and also applies to Canada's tax treaties.

Trigger Event

If a transaction is an "avoidance transaction", the Canada Revenue Agency (CRA) may deny the "tax benefit" that would otherwise result if it is found to be an "abuse" of the legislation read as a whole.

An avoidance transaction is any transaction that would otherwise result in a direct or indirect tax benefit, or that is part of a series of transactions that would otherwise result in a tax benefit. For GAAR purposes, a transaction includes an arrangement or event. However, a transaction will not be considered to be an avoidance transaction if it can reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

Even if a transaction is an avoidance transaction, GAAR will apply only if the transaction results in an abuse of the provisions of tax laws. In other words, GAAR applies only to transactions that lack a *bona fide* non-tax purpose and that result in an abuse of the tax laws.

The Canadian Supreme Court in the case of *Canada Trustco Mortgage Co. v The Queen ("Canada Trustco")*, 2005 SCC 54, established certain principles in the interpretation of GAAR:

- A finding of abuse is possible in the following situations:
  - the taxpayer uses specific provisions of the tax laws in order to achieve an outcome that those specific provisions seek to prevent;

- a transaction defeats the underlying rationale of the provisions that are relied upon; or
- an arrangement circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the 'object, spirit or purpose' of those provisions.

- Abuse is not established if it is reasonable to conclude that an avoidance transaction was within the 'object, spirit or purpose' of the provisions that confer the tax benefit.

As well, the Court noted as follows in respect of the consideration of economic substance in a GAAR analysis: *"While the economic substance of a transaction might be relevant at various stages of GAAR analysis, 'economic substance' has little meaning in isolation from the proper interpretation of specific provisions of the Act. Accordingly, any argument that is based on notions of 'economic substance' must be considered in light of the specific provisions being examined."*

The Canadian Supreme Court, in the case of *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, observed that the GAAR scheme requires that three questions be decided: (1) was there a tax benefit; (2) was the transaction giving rise to the tax benefit an avoidance transaction; and (3) was the avoidance transaction giving rise to the tax benefit abusive.

The Court further observed that *"in order to determine whether a transaction is an abuse or misuse of the Act, a court must first determine the object, spirit or purpose of the provisions that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids.*

While an avoidance transaction may operate alone to produce a tax benefit, it may also operate as part of a series of transactions that results in the tax benefit. While the focus must be on the transaction, where it is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is a part and the overall result that is achieved.

The analysis will lead to a finding of abusive tax avoidance: (1) where the transaction achieves an outcome the statutory provision was intended to prevent; (2) where the transaction defeats the underlying rationale of the provision; or (3) where the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose. These considerations are not independent of one another and may overlap".

Providing further guidelines, the Court emphasized that the transaction may have a tax purpose, but that does not necessarily mean that the tax purpose will always be the primary reason for the transaction. However, where a transaction takes place primarily for a non-tax purpose, there will be no avoidance transaction. In the absence of an avoidance transaction, the fact that a transaction may have a secondary tax benefit purpose will not trigger the application of GAAR.

Thus, where a corporate reorganization takes place, GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, GAAR may still not apply. It is only when a reorganization results in a tax benefit, is primarily for a tax purpose and is done in a manner found to be an abuse of a provision of the law, when the legislation is read as a whole, will GAAR apply.

Recently in *Oxford Properties Group Inc. v. The Queen,* 2016 TCC 204, the Tax Court of Canada held that GAAR did not apply to a series of transactions pursuant to which real properties were packaged into limited partnerships, "bumped" and sold to tax-exempt entities. The finding of the Supreme Court's decision in *Canada Trustco* was emphasized, concluding that taxpayers are entitled to structure their affairs to minimize tax provided they do not abuse the provisions of the Act.

Procedural Requirements

In *Canada Trustco*, the Canadian Supreme Court laid down the following procedural principles:

- The onus is on the taxpayer to refute the following:
  - the assertion that a tax benefit results from the transaction. It is not adequate, however, for the CRA to take the position that more tax would have been paid if the taxpayer had engaged in some other transaction or that the amount of tax paid is less than some notional amount that the CRA believes should have been paid; and
  - the assertion that the transaction was an avoidance transaction. The taxpayer would refute this assertion by showing a *bona fide* primary non-tax purpose for the transaction.

- If there is a tax benefit and an avoidance transaction, the burden then falls on the CRA to establish that there is abusive tax avoidance.

GAAR Analysis

The potential application of GAAR to a particular transaction requires a careful analysis of the facts and circumstances of each specific case in the context of the tax legislation – the specific provisions and the scheme of the tax statute as a whole. The object and spirit of the provisions being applied in order to claim a tax benefit must be determined. The facts and circumstances must then be considered in order to ascertain whether the transaction frustrated the object and spirit. This can be a very complex analysis and subject to differing interpretations. Expert advice on this issue is essential when undertaking complex transactions involving tax planning.

China

Background of the legislation

The Enterprise Income Tax Law (EITL), which came into effect on 1 January 2008, includes a general anti-avoidance provision (Article 47 of the EITL). In 2009, the State Administration of Taxation (SAT) issued Circular 2 (Special Adjustments Implementation Measures (Trial Implementation)), providing some general principles on the implementation of the GAAR (which is considered one type of special adjustment).

The SAT issued regulations on the application of GAAR - Administrative Regulations for the GAAR (Trial Implementation) (GAAR regulations) on 2 December 2014 effective from 1 February 2015. The new regulations are aimed to operate in conjunction with Article 47 of the EITL and Circular 2 to provide a detailed framework for administration of GAAR.

The SAT released a discussion draft of Special Tax Adjustment Implementation Measures on 17 September 2015 which should replace the existing Circular No. 2 of 2009 which is China's main transfer pricing guidance. The said draft includes Chapter 12 in relation to GAAR provisions. The draft guidelines were enacted vide SAT Bulletin [2016] No. 42 and No.64 published in June and October 2016 respectively. However, Bulletin 42 deals only with reporting of related party transactions and contemporaneous documentation, while Bulletin 64 handles administration on advance pricing arrangement. There will be additional regulations issued to complete the revision of Circular No. 2.

Trigger Events

Article 47 of the EITL provides: *"If an enterprise engages in a business arrangement without bona fide commercial purposes that results in reducing its taxable revenue or taxable income, the tax bureau has the right to make adjustments based on reasonable methods."*

According to GAAR regulations, a tax avoidance arrangement is defined as an arrangement having the following two features:

- the sole purpose or main purpose of the arrangement is to obtain tax benefit;
- a form of arrangement, permitted under the tax law, is used to obtain tax benefits, but its use is inconsistent with the economic substance of the arrangement.

GAAR regulations define a tax benefit as a reduction, exemption or deferral of an amount of EIT that otherwise would be payable.

Under Circular 2, the tax authorities may initiate a GAAR audit of enterprises that enter into the following arrangements:

- abuse of tax incentives;
- abuse of treaties;
- abuse of the corporate structure;
- use of tax havens for the avoidance of taxes; and
- other business arrangements without *bona fide* commercial purposes.

SAT has clarified that an adjustment made to an indirect transfer under SAT Announcement [2015] Bulletin No. 7 (which modifies Circular No. 698) is considered as an application of GAAR.

GAAR will not apply to the following according to GAAR regulations:

- arrangements that do not involve a cross-border transaction or payment (i.e. purely domestic transactions or payments); and
- illegal acts, such as avoidance of the payment of tax, fraud in obtaining a tax credit, other tax fraud or refusal to pay tax.

Procedure for applying GAAR

GAAR regulations stipulate procedures for applying GAAR. Tax authorities identify potential cases for investigation based on the information submitted by taxpayers or gathered through their own channels.

GAAR audits and adjustments must be carried out only with the approval of the provisional tax authorities and the SAT.

Any of the following methods can be used by the tax authorities to deny tax benefit obtained through a tax avoidance arrangement:

- Re-characterizing the arrangement in whole or in part;
- Disregarding the existence of a party to the transaction for tax purposes, or treating parties to a transaction as a single entity;
- Re-characterizing the relevant income, deductions, tax incentives, foreign tax credits, etc. or reallocating these items among parties to the transaction; or
- Other reasonable methods

SAARs

Apart from GAAR, China has some specific rules like:

- Transfer pricing
- Thin capitalization
- Controlled foreign companies
- Recognition of a beneficial owner for treaty purposes

For the arrangements which are covered by the special tax adjustments rules such as regulations on transfer pricing, cost sharing agreements, controlled foreign corporations, or thin capitalization, etc., these special tax provisions should be applied first. However, that does not shield the transaction from the applicability of GAAR provisions as GAAR has a residual application.

Impact on Treaty usage

Under Article 58 of the EITL, treaty provisions prevail in case there is a conflict with the provisions of the EITL.

Under Article 6 of the GAAR regulations, it has been clarified that for the arrangements that are covered by tax treaty provisions of beneficial ownership or limitation of benefit, etc., the tax treaty provisions should be applied first.

It should be noted that the more recent treaties concluded by China include provisions specifically stating that main purpose test would operate to counter transactions without justified commercial purpose but to take advantage of the treaty benefits.

Germany

Background of the legislation

Section 42 of the German Tax Code (The Fiscal Code of Germany) provides for GAAR. The said provision was introduced in the German Tax Code in 1977. Later, in the year 2008, the said provision was amended to clear ambiguity and intensify the applicability of GAAR.

Trigger Event

The anti-avoidance provisions under section 42 of the German Tax Code as introduced in the year 1977 stated that it shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes.

Under the said provisions, the term "abusing" was not elaborated and thus, it was left on the Federal Courts to interpret the term "abuse".

In order to remove the aforesaid ambiguity, the section was amended in the year 2008 to elaborate the term 'abuse'. It states that an abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. Further, the section clarifies that the anti-abusive provisions shall not apply where the taxpayer provides evidence of non-tax reasons for the selected option which are relevant when viewed from an overall perspective.

Thus, following are the three important features which shall decide the applicability of GAAR based on the amended provisions:

- Inappropriate legal option which constitutes abuse
- Presumption of abuse can be rebutted by the taxpayer by demonstrating commercial reasons (i.e. non-tax reasons) for entering into such a transaction
- Special anti-abuse provisions shall supersede GAAR provisions

It may be highlighted that the term 'inappropriate legal option' has not been defined under the tax code. The German Federal Tax Courts have concluded that inappropriate legal structures are those in which two unrelated and reasonable parties would not have chosen to achieve a specific business goal.

Further, unlike many other jurisdictions, GAAR may not apply to transactions which are covered under a SAAR even if the transaction does not fulfil the conditions to trigger SAAR, i.e. once there is a SAAR for a particular transaction, even if the said transaction does not fulfil all the criteria of SAAR in order to invoke legal consequences, GAAR shall not apply.

Procedure for Applying GAAR

The GAAR provisions shall be invoked by the Tax Officer generally on discovering any misconduct during the course of tax audit. The application of GAAR shall result in correct tax being imposed on the taxpayer along with interest. The Tax Authorities shall re-characterize the transaction applying the GAAR provisions and base their tax audit on the said structure for determining the correct tax amount payable.

Further, the taxpayer has the following three different options available in order to obtain certainty as regards the applicability of GAAR provisions in case of a particular transaction:

- Advance rulings
- Affirmation after Tax Audits
- Agreements on Facts

Specific Anti-Avoidance Rules

Apart from GAAR, Germany has specific rules concerning:

- Transfer pricing
- CFCs
- Anti-arbitrage rule for hybrids
- Interest deduction limitation rules
- Anti-Treaty/Directive shopping Provisions

Impact on Treaty usage

German Federal Courts have held that domestic GAAR provisions can override treaty provisions and thus, section 42 of the German Tax code shall be applicable.

Singapore

General

Tax avoidance normally involves an arrangement that is artificial, contrived or has little or no commercial substance. While such an arrangement may fulfil the legal requirements of the law, it is designed to obtain a tax advantage that is not intended by Parliament.

Background of legislation

Singapore's GAAR is contained in Section 33 of the Income Tax Act ('ITA') since 1988.

Trigger Event

It applies where the Comptroller of Income tax (CIT) is satisfied that the purpose or effect of any arrangement is directly or indirectly: (section 33(1))

- to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person;
- to relieve any person from any liability to pay tax or to make a return under the ITA; or
- to reduce or avoid any liability imposed or which would otherwise have been imposed under the ITA.

For this purpose, 'arrangement' includes a scheme, trust, grant, covenant, agreement, disposition, transaction, and includes all steps by which it is carried into effect (section 33(2)).

GAAR does not apply to any arrangement carried out for *bona fide* commercial reasons and had not as one of its main purposes the avoidance or reduction of tax (section 33(3)(b)).

It empowers the CIT to disregard or vary the arrangement and make relevant adjustments (such as re-computation of gains or profits or imposition of tax liability) to counter the tax advantage sought to be obtained.

The scope, construction and application of GAAR was examined by the Court of Appeal (CA) in the case of CIT v AQQ [2014] SGCA 15.

The case concerns a restructuring and financing arrangement carried out through AQQ, a newly incorporated company. AQQ acquired 100% shares in four Singapore companies (which had significant amount of unutilized tax credits) from related companies. The purchase of these shares was financed by round-tripping financing arrangements through banks located in different countries. Through this, AQQ claimed deduction for interest expenses against the dividend paid by the subsidiaries, leading to huge claim of tax refund by AQQ. The CA held that the restructuring and financing arrangements were not commercial transactions under which any tax avoidance or reduction was merely incidental. The CA ruled that one of the main purposes of the restructuring and financing arrangement was to obtain a tax benefit by creating interest deductions to reduce the tax payable on the dividend income.

Thereafter, another case, i.e. GBF v CIT (2016) SGITBR 1, was decided largely based on principles laid down in AQQ's case. In GBF's case, the Income Tax Board of Review concluded that GAAR applied to an arrangement by a medical practitioner, in which "physician compensation" was paid to a partnership comprising two corporate partners owned by the taxpayer and his wife respectively.

e-Tax Guide on GAAR provisions and application

In July 2016, the Inland Revenue Authority of Singapore ('IRAS') published the first edition of its e-Tax Guide on "Income Tax: The General Anti-avoidance Provision and its Application".

The e-Tax Guide sets out the CIT's approach to the construction of GAAR in Section 33 of the ITA and contains examples of arrangements which the CIT views as tax avoidance; it does not cover arrangements that are covered by specific anti-avoidance provisions of the ITA and/or involve tax evasion.

The interpretation of Section 33 as per the said Guide is essentially as per the principles laid down by the CA in the case of CIT v AQQ (supra).

It propounds the "scheme and purpose approach" of interpretation as follows:

- Step 1: Whether an arrangement *prima facie* falls within any of the three threshold limbs in Section 33(1) of the ITA. The CIT will consider objectively based on the observable acts by which an arrangement is implemented
- Step 2: Whether the taxpayer may avail himself of the statutory exception under section 33(3) (b) of the ITA. The CIT will consider the taxpayer's subjective commercial motives for entering into the arrangement and subjective consequences that the taxpayer wishes to obtain. The CIT has clarified that *bona fide* commercial transactions which are carried out not in pursuance of any tax avoidance arrangement will not come within the scope of Section 33 of the ITA.
- Step 3: Whether the tax advantage obtained arose from the use of a specific provision in the ITA. The CIT will consider whether the tax advantage obtained by the taxpayer arose from the use of a specific provision in the ITA that was "within the intended scope and Parliament's contemplation and purpose, both as a matter of legal form and economic reality within the context of the entire arrangement".

Some of the factors that the CIT will consider include:

- The manner in which the arrangement was carried out;
- The role of all relevant parties and any relationship they may have with the taxpayer;
- The economic and commercial effect of documents and transactions;
- The duration of the arrangement; and
- The nature and extent of the financial consequences that the arrangement has for the taxpayer

The examples set out in the e-Tax Guide indicate that the following categories may be considered as having a characteristic of tax avoidance:

- Round tripping of funds
- Setting up of more than one entity or change in business form for the sole purpose of obtaining tax advantage
- Attribution of income not aligned with economic activity

Whereas, the following have been discussed in examples of genuine commercial transactions to which GAAR does not apply:

- Placement of monies in a local bank or with a bank outside Singapore
- Provision of housing accommodation to employees directly instead of giving a taxable housing allowance
- Non-remittance of foreign income

South Africa

General

GAAR operates as one of the measures to counter tax avoidance, and is generally considered as a residual measure, which may apply in addition to or as an alternative to any other or specific anti-avoidance provision.

Background of the legislation

During 2006, the Income Tax Act 58 of 1962 ("the Income Tax Act") was amended to enable the South African Revenue Service ("SARS") to more effectively combat tax avoidance in South Africa. Section 103(1), the general anti-avoidance provision, was repealed and the GAAR was introduced. The GAAR is contained in Part IIA of Chapter III (section 80A – L) of the Income Tax Act and specifically applies to impermissible avoidance arrangements as defined.

A provision against tax avoidance applies where:

- an impermissible avoidance agreement has been entered into with its sole or main purpose being to obtain a tax benefit; and
- in the context of business:
  - it was entered into or carried out in a manner that would not normally be employed for *bona fide* business purposes other than for obtaining a tax benefit; or
  - it lacks commercial substance, taking into account the provisions of section 80C;
- in the context other than business, it was entered into or carried out by means or in a manner not normally employed for a *bona fide* purpose, other than obtaining a tax benefit; or
- it has created rights or obligations which would not normally be created between persons dealing at arm's length, or it would result directly or indirectly in the misuse or abuse of the provisions of the Income Tax Act.

Tax Consequences

The Commissioner may determine the following consequences under the Income Tax Act if the above requirements are met:

- disregard, combine or re-characterize the arrangement or any step thereof;
- disregard any accommodating or tax-indifferent party or treat this party and any other party as one and the same person;
- deem the parties who are connected persons in respect of each other as one and the same person;
- re-allocate any income, receipt or accrual of a capital nature or expenditure;
- re-characterize any income of a capital nature as income of a revenue nature; or
- treat the transaction as if it has not been carried out, or in any other manner that the Commissioner deems adequate for the prevention or diminution of the tax benefit.

Trigger Event

The presence of certain criteria is considered as indicative of tax avoidance. These include:

- the legal substance of the arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps;
- the presence of round trip financing;
- the presence of an accommodating or tax-indifferent party (described as a party for whom the amounts received from the arrangement are not subject to normal tax, or the tax liability is significantly offset by an expenditure incurred by that party in terms of the arrangement);
- the presence of elements which have the effect of offsetting or cancelling each other.

United Kingdom

Background

The GAAR were released as part of the Finance Act in 2013, following consultations and draft guidance throughout 2012. The GAAR is a part of the approach of the UK tax authority (HMRC) to managing the risk of tax avoidance. It has been introduced to strengthen HMRC's anti-avoidance strategy and to help tackle abusive avoidance.

The GAAR has effect in relation to any tax arrangements entered into on or after 17 July 2013; any tax arrangements entered into before that day are not covered by the GAAR.

Arrangements covered by the GAAR

The purpose of the GAAR is to counteract tax advantages arising from tax arrangements that are abusive. The GAAR applies to the following taxes:

- Income tax
- Corporation tax
- Capital gains tax
- Petroleum revenue tax
- Inheritance tax
- Stamp duty land tax
- Annual tax on enveloped dwelling
- National insurance.

In order to determine whether the GAAR applies, the first question is whether a tax advantage has arisen. According to the legislation, a tax advantage includes:

- Relief or increased relief from tax
- Repayment or increased repayment of tax
- Avoidance or reduction of a charge to tax or an assessment to tax
- Avoidance of a possible assessment to tax
- Deferral of a payment of tax or advancement of a repayment of tax
- Avoidance of an obligation to deduct or account for tax.

An arrangement is a "tax arrangement" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangement.

The legislation defines tax arrangements as abusive if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances, including:

- Whether the substantive results of the arrangement are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions.
- Whether the means of achieving those results involve one or more contrived or abnormal steps, and
- Whether the arrangements are intended to exploit any shortcomings in those provisions

Abuse

In assessing whether the GAAR applies, it will usually be necessary to identify an abusive arrangement by determining whether the arrangements would achieve their tax avoiding purpose under the rest of the tax code (i.e. if the GAAR rules did not apply). In such cases, HMRC may likely challenge the arrangements by both arguing GAAR should apply, as well as using other technical arguments.

Broadly speaking, HMRC would expect to apply the GAAR when the course of action taken by the taxpayer aims to achieve a favourable tax result that Parliament did not anticipate when it introduced the tax rules in question and where that course of action cannot reasonably be regarded as reasonable.

In particular, the legislation identifies particular elements to consider in determining an abuse:

- the concept of a reasonable course of action taken by the taxpayer in relation to the relevant tax provisions and whether the arrangements in question cannot reasonably be regarded as a reasonable course of action;
- comparing the substantive results of the arrangements with the principles on which the relevant tax provisions are based, and with the policy objectives of those provisions;
- seeing whether there are contrived or abnormal steps;
- seeing whether the arrangements are intended to exploit any shortcomings in the relevant provisions.

Burden of proof

The burden of proof is with the UK tax authorities (HMRC) and there are certain matters that HMRC must show to apply the GAAR. For example, it is HMRC's responsibility to establish that the arrangements are abusive. HMRC will apply a "double reasonableness" test which requires them to show that the arrangements "cannot reasonably be regarded as a reasonable course of action."

Procedural requirements

Taxpayers will be notified by a designated HMRC officer that they have obtained a tax advantage. The taxpayer then has 45 days to respond, otherwise HMRC will refer the matter to the GAAR advisory panel. Where there are representations by the taxpayer and the HMRC officer still considers a tax advantage has been obtained, the matter is referred to the panel. The panel will issue an opinion notice and the designated officer will then consider if "counteraction" is necessary under GAAR (i.e. to remedy for the tax advantage deemed to have been taken) and inform the taxpayer.

Counteractions and penalties

If the officer considers a counteraction to be necessary then the tax advantages that would arise from the arrangements are to be counteracted by the making of adjustments on a just and reasonable basis. There may also be a penalty of 60% of the value of the counteracted adjustment.

Other information

HMRC have stated that just because something is not covered by the GAAR, this does not mean that the abuse will not be tackled in another way, including using existing anti-avoidance methods.

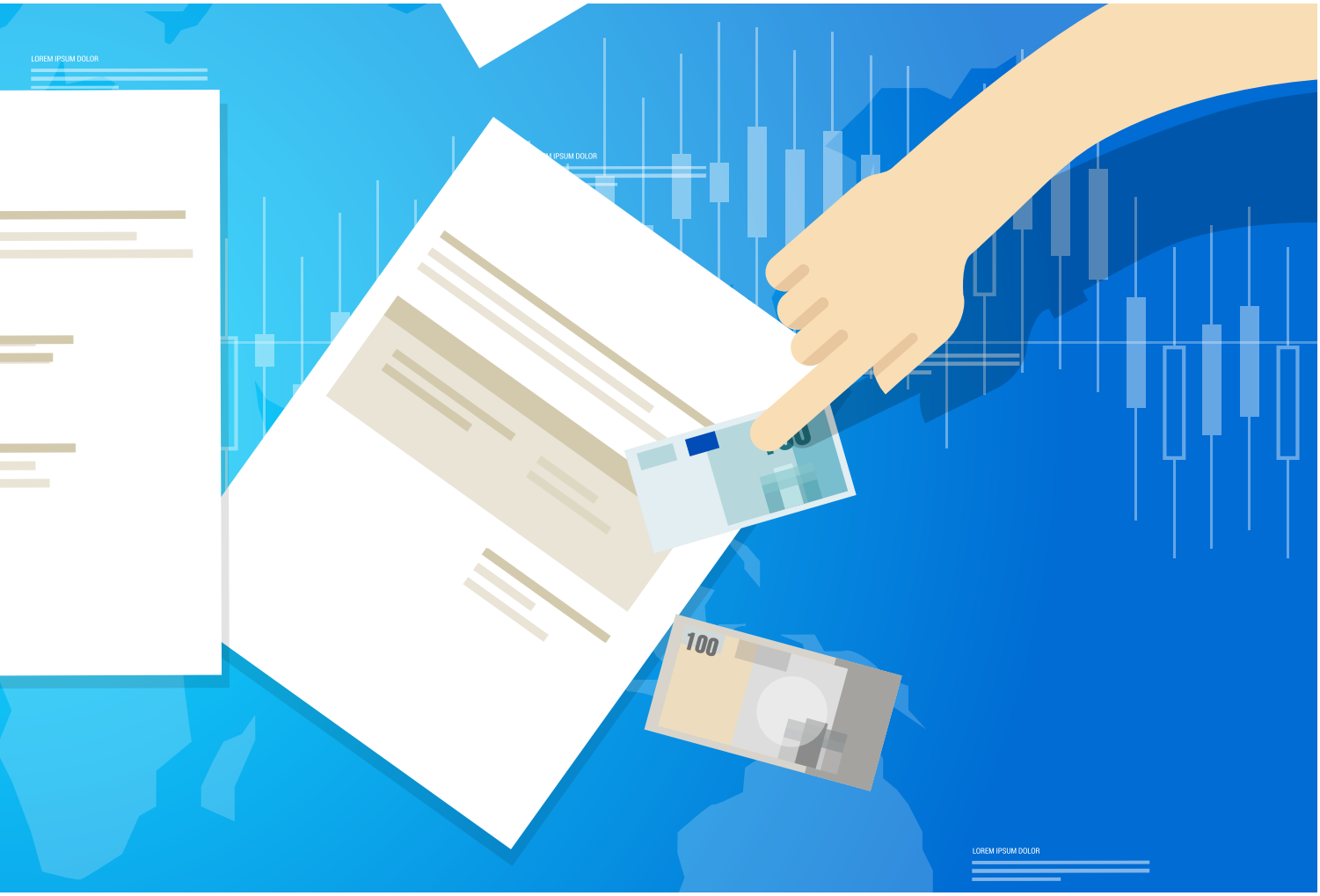
Certain reliefs such as business property relief, capital allowances (i.e. tax depreciation) and patent box should not be caught by the GAAR, as long as they are used constructively to encourage and support business growth. Furthermore, should the tax arrangements accord with established practice, and should HMRC have previously indicated its acceptance of that practice, then the arrangements should not fall within the scope of the GAAR.

Indian Regime

Background

GAAR was introduced in India for the first time in the then proposed Direct Taxes Code Bill ("DTC"), 2009. Some safeguards and modifications were proposed thereafter. In February, 2012, the CBDT formed a Committee to provide recommendations for formulating guidelines to implement the GAAR provisions under DTC and to draft a circular so as to ensure that GAAR is not applied indiscriminately. Subsequently, the Finance Bill, 2012 proposed to introduce the GAAR provisions in the Income tax Act, 1961 with effect from 1 April 2012. However, in view of the concerns raised by various stake holders, certain amendments were proposed in the GAAR provisions and its implementation was deferred to 1 April 2013.

In June 2012, the Committee formed by the CBDT released draft guidelines on GAAR. However, it was felt that the guidelines did not provide the required clarity on GAAR. Therefore, an Expert Committee under the chairmanship of Dr. Parthasarathi Shome was constituted by the then Prime Minister to undertake stakeholder consultations and to finalise the guidelines for GAAR after widespread consultations so that there is a greater clarity. Based on the stakeholder comments and feedback, the committee vetted and reworked the guidelines. The committee published its draft report for public comments. After examining



the responses to the draft report, the committee submitted its final report on 30 September 2012, which was made available to the public on 14 January 2013. Some of the recommendations were incorporated in the GAAR provisions by the Finance Act, 2013 and its implementation was deferred to 1 April 2015. The Finance Act, 2015 further deferred GAAR implementation to 1 April 2017.

Separately, in September 2013, the CBDT notified rules for application of GAAR. The investments made before 30 August, 2010 (i.e. date of introduction of the DTC, 2010) were grandfathered. The date was later extended to 31 March 2017. In order to provide further clarity on GAAR, the CBDT recently issued various clarifications on applicability of GAAR.

GAAR – trigger event

As per the GAAR provisions, an arrangement entered into by a taxpayer may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined as per the said provisions. It has been clarified that the GAAR provisions may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

Meaning of arrangement

An "arrangement" 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.

Impermissible avoidance arrangement
An impermissible avoidance arrangement is defined to mean an arrangement, the main purpose of which is to obtain a tax benefit, and it—

a. creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;

b. results, directly or indirectly, in the misuse, or abuse, of the provisions of the Indian domestic tax law;

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

d. is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

It is further provided that an arrangement shall be presumed, unless it is proved to the contrary by the taxpayer, to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

Arrangement to lack commercial substance
An arrangement shall be deemed to lack commercial substance, if—

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

b. it involves or includes—
   i. round trip financing;
   ii. an accommodating party [a party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the GAAR provisions) for the taxpayer whether or not the party is a connected person in relation to any party to the arrangement];
   iii. elements that have effect of offsetting or cancelling each other; or
   iv. a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

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

d. it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the GAAR provisions).

It is also clarified that the following may be relevant but shall not be sufficient for determining whether an arrangement lacks commercial substance or not, namely:—
   i. the period or time for which the arrangement (including operations therein) exists;
   ii. the fact of payment of taxes, directly or indirectly, under the arrangement;
   iii. the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

Consequences of impermissible avoidance arrangement.
If an arrangement is declared to be an impermissible avoidance arrangement, the tax authorities have powers to determine the consequences in relation to the arrangement, including denial of tax benefit or a benefit under a tax treaty, as they deem appropriate, including by way of, but not limited to the following, namely:—

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

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

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

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

e. reallocating amongst the parties to the arrangement—
   i. any accrual, or receipt, of a capital nature or revenue nature; or
   ii. any expenditure, deduction, relief or rebate;

f. treating—
   i. the place of residence of any party to the arrangement; or
   ii. the situs of an asset or of a transaction,
   iii. at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

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

For the purposes of above,—
   i. any equity may be treated as debt or vice versa;
   ii. any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or
   iii. any expenditure, deduction, relief or rebate may be re-characterized.

It is further provided that in determining whether a tax benefit exists,—
   i. the parties who are connected persons (as defined under the GAAR provisions) in relation to each other may be treated as one and the same person;
   ii. any accommodating party may be disregarded;
   iii. the accommodating party and any other party may be treated as one and the same person;
   iv. the arrangement may be considered or looked through by disregarding any corporate structure.

It is also clarified that, where a part o an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such step only.

GAAR not to apply in certain cases

The GAAR provisions shall not apply to -

a. an arrangement where the tax benefit in the relevant tax year arising, in aggregate, to all the parties to the arrangement does not exceed INR 30 million;

b. a Foreign Portfolio Investor (FPI) who does not claim tax treaty benefit and who has invested in listed or unlisted securities with the prior permission of the competent authority under the relevant regulations;

c. a non-resident, in relation to investment made, directly or indirectly, in a Foreign Portfolio Investor ("FPI") by way of offshore derivative instruments or otherwise;

d. any income accruing or arising, or deemed to accrue or arise, received or deemed to be received from transfer of investments made before 1 April 2017

As regards grandfathering, it is clarified that, without prejudice to clause (d) above, the GAAR provisions shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after 1 April 2017.

Procedure for applying GAAR

In order to ensure that GAAR is invoked only in deserving cases, a two-step approval process has been prescribed before GAAR provisions can be invoked. The same is explained below:

- The tax officer, if considers necessary to invoke GAAR against any taxpayer, is required to make a reference to the Principal Commissioner or Commissioner.
- If the Principal Commissioner or Commissioner, on receipt of a reference from the tax officer, is of the opinion that GAAR provisions are required to be invoked, he shall issue a notice to the taxpayer for submitting objections (if any) and providing an opportunity of being heard.
- In case the taxpayer does not furnish any objection to the notice, the Principal Commissioner or Commissioner shall issue such directions as he deems fit in respect of declaration of the arrangement to be an impermissible avoidance arrangement.
- In case the taxpayer objects to the proposed action, and the Principal Commissioner or Commissioner is not satisfied by the explanation of the taxpayer, then, he shall make a reference to the Approving Panel for the purpose of declaration of the arrangement as an impermissible avoidance arrangement. In case the Principal Commissioner or Commissioner is satisfied, after having heard the taxpayer, that the GAAR provisions are not to be invoked, he shall communicate the same to the tax officer by an order in writing.
- The Approving Panel shall issue such directions as it deems fit. However, any directions prejudicial to the interests of the taxpayer or the revenue shall not be issued unless an opportunity of being heard is given to the taxpayer or the tax officer, as the case may be.
- The directions issued by the Approving Panel shall be binding on the taxpayer and the Principal Commissioner or Commissioner and the income-tax authorities subordinate to him.
- No order of assessment or reassessment shall be passed by the tax officer without prior approval of the Principal Commissioner or Commissioner, if any tax consequences have been determined in the order under the GAAR provisions.

Advance Ruling

Any resident or non-resident taxpayer can approach the Authority for Advance Ruling to obtain a ruling on whether an arrangement, which is proposed to be undertaken by him, is an impermissible avoidance arrangement as referred to in the GAAR provisions.

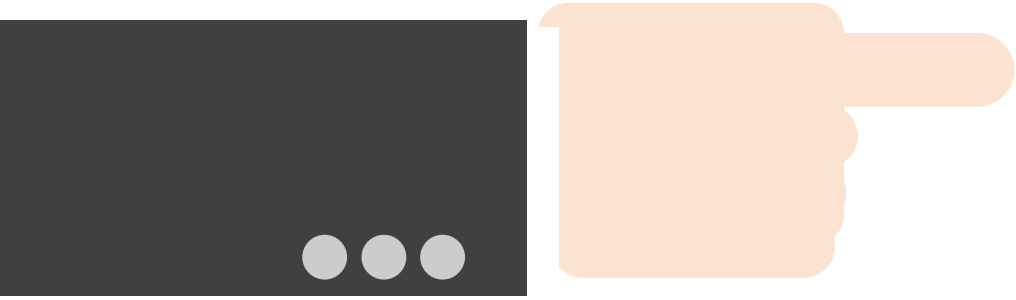
Clarifications issued by the CBDT

Considering the subjectivity around GAAR, stakeholders and industry associations had approached the government to issue clarifications / directions. Acceding to the representations, the CBDT constituted a working group in June 2016 which submitted its comments to CBDT. After considering the comments of the working group, the CBDT recently[10] issued clarifications on implementation of GAAR.

A synopsis of the clarifications issued by the CBDT is given below:

Tax treaty v. GAAR

- 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 Limitation of Benefit ("LOB") clause in the relevant tax treaty, GAAR shall not be invoked.
- GAAR shall not be invoked merely on the ground that the taxpayer is located in a tax efficient jurisdiction. If the jurisdiction of a FPI is finalised based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefits, GAAR will not apply.



[10] On 27 January 2017

SAAR v. GAAR

- SAAR may not address all situations of abuse and there is need for GAAR in the domestic legislation. The provisions of SAAR and GAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.

Right of the taxpayer to select an alternative

- GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.
- Similarly, if a taxpayer claims treaty benefits in one year and opts to be governed by the domestic law in another year, GAAR will not apply to deny such a claim.

Judicious implementation

- If the approving authority (Commissioner / Principal Commissioner / Approval Panel) has rejected tax officer's request to invoke GAAR provisions in respect of an arrangement in any year, GAAR will not be invoked in respect of such arrangement in subsequent years provided the facts and circumstances remain the same.
- GAAR will not apply to an arrangement in respect of which an advance ruling has been obtained from the Authority for Advance Rulings.
- GAAR will not apply to an arrangement sanctioned by any Court where the Court has explicitly and adequately considered the tax implications of the arrangement.

Grandfathering benefit

- Grandfathering in respect of income from transfer of investments made before 1 April 2017 would be available to an investor on shares acquired after 31 March 2017, if the shares are acquired by such investor through conversion of compulsorily convertible instruments issued before 1 April 2017 provided the terms of conversion were finalized at the time of original acquisition of such instruments.
- Grandfathering would also be available in respect of shares acquired consequent to a share split or consolidation or through bonus issue, provided the original shares were acquired before 1 April 2017.
- Grandfathering benefit is not available in respect of lease contracts and loan arrangements as they are not 'investments'.

GAAR – as deterrent

- Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor to determine whether an arrangement lacks commercial substance and accordingly, a definite timeline for existence of an arrangement (where GAAR provisions will not apply) is not required.
- GAAR is an anti-avoidance provision with deterrent consequences. Therefore, in event of a particular consequence being applied in the hands of one of the participants as a result of GAAR provisions, corresponding adjustment in the hands of another participant will not be made.
- GAAR provisions apply to tax benefit enjoyed in Indian jurisdiction due to an impermissible arrangement or part of arrangement. Further, the exemption limit for tax benefit up to INR 30 million cannot be restricted to a single taxpayer alone and impact on all parties to the arrangement is to be considered.

Comparison of the proposals with legislation in other jurisdictions

A comparison of the Indian GAAR provisions *vis-à-vis* other countries (discussed in the preceding sections) indicates that the provisions are broadly on the lines incorporated by South Africa. However, the South African draft guidance indicates that *"in essence, a tax benefit may be denied under the GAAR if such tax benefit would misuse or abuse the object, spirit or purpose of the provisions of the Income Tax Act that are relied upon for the tax benefit. This clearly requires a purposive approach to interpreting the provisions of the Income Tax Act, which is already the accepted approach to legislative interpretation in South Africa".*

Further, as indicated under South Africa GAAR, the purpose test is a more objective test, wherein the sole or main purpose of the arrangement itself is the relevant purpose and no longer the subjective purpose of the taxpayer.

Thus, in implementation, one would need to adapt the principle that the "tax benefit" would misuse or abuse the object, spirit or purpose of the provisions of the Income Tax Act. However, under the Indian GAAR, even where the main purpose of a step in the transaction, or the part of a transaction

is to obtain a 'tax benefit', the arrangement would be presumed to be carried out with the main purpose of obtaining a tax benefit. Though the provisions indicate the establishment of main purpose, it is unclear as to the methodology of determining the main purpose.

Further, the absence of simultaneous business purpose or a *bona fide* purpose test and the mere presence of a tax benefit give rise to the presumption that the avoidance arrangement was designed and entered into solely or mainly to obtain a tax benefit. This may also lead to greater onus on the taxpayer to establish that the main purpose was not the 'tax benefit'. Hence, it is imperative that the criterion of 'tax benefit' should not be made the sole purpose and object of invoking GAAR provisions.

As such, it may be appropriate to adopt the approach under the Canadian provisions wherein it is stated that an avoidance transaction means any transaction a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. It is further provided that the provisions would be applicable to a transaction only if it may reasonably be considered that the transaction would result directly or indirectly in a misuse of the provisions of the Act, treaty etc., or would result directly or indirectly in an abuse having regard to those provisions.

Thus, under Canadian law and as interpreted by their Courts, the misuse or abuse test would involve a two-part inquiry.

- The first is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose which would be the question of law.
- The second is to examine the factual context of a case in order to determine whether the avoidance arrangement defeated the object, spirit or purpose of the provisions under consideration. This would generally be a question both of law and fact, in which the onus will be upon the Commissioner to assess the factual element of the case.

For providing guidance to the taxpayer with respect to application of the GAAR, the CRA has issued a circular which also includes various examples to illustrate the approach that Revenue Canada will take in certain situations. A similar guidance has also been issued by the UK Government.

In India, although the CBDT has issued clarifications on certain issues raised by stakeholders, it would be helpful for the taxpayers if the application of GAAR is explained by way of examples / illustrations. The report of the Expert Committee headed Dr. Shome did contain illustrative cases explaining GAAR applicability. However, they have not been incorporated in the clarifications issued by the CBDT.

Way forward

GAAR will finally be effective in India from 1 April 2017, almost eight years after it was first introduced in the then proposed DTC, 2009. The approach of the government in the entire process of introduction of GAAR has been consultative which is quite appreciable. Amendments have been made in the GAAR provisions to address the concerns of the stakeholders. Safeguards have been incorporated to ensure that GAAR provisions are not misused. The requirement that GAAR will be invoked only after obtaining permission from the Approving Panel is commendable and shows the intention of the Government to ensure judicious implementation. Monetary threshold has also been provided to target only high value arrangements. Investments made upto 31 March 2017, have been grandfathered. Clarifications have also been provided on various issues raised by the stakeholders although it would be helpful if some examples are also provided to explain the approach which the government will take in specific situations. Reference in this regard may be made to Canada and UK. Detailed guidelines, as issued in some of the other jurisdictions, would also be of great help for both the tax authorities as well as taxpayers.

For taxpayers, it will be imperative to examine their existing arrangements to evaluate if they may fall within the boundary of being considered as impermissible avoidance arrangements and thereby hit by the consequences provided in the GAAR provisions which can be quite onerous. This exercise may also help them take corrective actions to mitigate the said exposure.

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