



Tax alert: GAAR can take precedence over SAAR

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The Telangana High Court, based on the facts of the case, has held that the transactions under consideration do not qualify as permissible under tax laws and therefore, the provisions of Chapter X-A of the Income-tax Act, 1961 (ITA) dealing with General Anti-Avoidance Rules (GAAR), would become applicable.

In a nutshell



By virtue of the non obstante clause under section 95(1) of the ITA dealing with the applicability of the GAAR, the provisions of Chapter X-A get overriding effect over and above the other existing provisions of law.



The applicability of either GAAR or Specific Anti-Avoidance Rules (SAAR) would be determined on a case by-case basis.



The business intent behind a transaction could serve as strong evidence that the transaction isn't deceptive or artificial arrangement



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Background:

- During Financial Year (FY) 2018-19, corresponding to Assessment Year (AY) 2019-20, the taxpayer¹ had sold certain shares of a group company (say A Co) to another company (say B Co).
- Prior to the sale of shares of A Co, A Co had issued bonus shares to its shareholders in the ratio of 5:1. Owing to the bonus issue, the face value of each share of A Co reduced to 1/6th of its value. Thus, the sale of A Co shares resulted in a short-term capital loss (STCL) to the taxpayer.
- In the return of income for the year under consideration (i.e. FY 2018-19, corresponding to AY 2019-20), the taxpayer claimed set-off of STCL from sale of A Co shares against the long-term capital gains made on sale of another company shares (say C Co). The taxpayer, thus, filed the return of income reporting the income under the head 'capital gains' arising out of the sale of C Co shares after adjusting the STCL incurred on the sale of A Co shares and paid the requisite income-tax.
- During the course of audit proceedings, the Principal Commissioner of Income-tax (PCIT) under section 144BA of the ITA, sought to treat the transaction as an Impermissible Avoidance Arrangement (IAA) as per the General Anti-Avoidance Rules (GAAR) provisions under Chapter X-A of the Income-tax Act, 1961 (ITA). The key facts / contentions in this regard were as follows:
 - In the Annual General Meeting (AGM) held on 27 February 2019, the authorized share capital of A Co was increased. The AGM further decided to allot shares (say X number of shares) to the taxpayer and (say Y number of shares) to the other shareholder (S Co).
 - Immediately thereafter, the taxpayer purchased Y number of shares of A Co, from S Co.
 - On 4 March 2019, A Co declared bonus shares in the ratio of 5:1. As a consequence, the value of shares declined from say INR 100 to INR 10. On 14 March 2019, the taxpayer sold certain A Co shares to B Co at INR 10, thereby resulting in a business loss.
 - Immediately thereafter, the taxpayer transferred the newly issued A Co shares (purchased at INR 10) to another related entity, which was without any purpose.
 - The purchaser, B Co, did not have sufficient sources of funds to buy shares of A Co. The funds in this regard were provided by S Co. The money funded by S Co was returned by way of rotation of funds from within the group itself in the form of transfer from one group concerned to another.
 - Thus, the transaction was nothing but round tripping of funds with no commercial substance. The entire exercise was done with the malafide intention of avoiding payment of tax by creating losses, without any economic, rationale and commercial substance.
- Aggrieved, the taxpayer filed a writ petition before the Telangana High Court (HC).

The key contention of the taxpayer before the HC was that since there is a special provision relating to avoidance of tax envisaged under the ITA [viz. section 94(8) of the ITA (relating to avoidance of tax by certain transactions in securities)], under the said circumstances, the general provision of law of anti-avoidance could not be applied and the Revenue was required to scrutinize the case of the taxpayer strictly within the four corners of the provisions of chapter X of the ITA i.e., [Special Anti-Avoidance Rules (SAAR)] and chapter X-A of the ITA i.e., GAAR could not be invoked.

Relevant provisions in brief:

Relevant extract of section 94² of the ITA

“(8) Where—

¹ Ayodhya Rami Reddy Alla v PCIT [Writ Petition Nos. 46510 and 46467 of 2022] (Telangana HC)

² Prior to amendment by Finance Act 2022

(a) any person buys or acquires any units within a period of three months prior to the record date;
(b) such person is allotted additional units without any payment on the basis of holding of such units on such date;
(c) such person sells or transfers all or any of the units referred to in clause (a) within a period of nine months after such date, while continuing to hold all or any of the additional units referred to in clause (b),
then, the loss, if any, arising to him on account of such purchase and sale of all or any of such units shall be ignored for the purposes of computing his income chargeable to tax and notwithstanding anything contained in any other provision of this Act, the amount of loss so ignored shall be deemed to be the cost of purchase or acquisition of such additional units referred to in clause (b) as are held by him on the date of such sale or transfer...

...Explanation.—For the purposes of this section,—

... (b) "securities" includes stocks and shares;...

... (d) "unit" shall mean,—...

Decision of the HC:

The HC noted that the issue arising in the case under consideration was whether the transaction entered into by the taxpayer was covered by section 94(8) of the ITA i.e., SAAR or the transaction was an IAA under Chapter X-A of the ITA i.e., GAAR. In this regard, the HC noted /observed the following:

Special provision of law vs general provision of law

- The HC noted the fact that the special provision of law i.e., section 94(8) of the ITA, was already present, when the general provision of law, GAAR, had been subsequently enacted by an amendment. Normally, it is the reverse; the general provision of law already being in force, the special provision of law is subsequently enacted.
- It was in those circumstances that the Supreme Court of India (SC), as also the various High Courts, had repeatedly held that when a special provision of law is enacted, then the general provision of law would not and could not be invoked.

GAAR

- Chapter X-A begins with a non-obstante clause, wherein section 95(1), dealing with the applicability of the GAAR, it has been held that, notwithstanding anything contained in the ITA, if the Assessing Authority finds that an arrangement entered into by the taxpayer is an IAA, the determination has to be done in respect of the consequential tax arising therefrom and shall be subject to the provisions of Chapter X-A.
- By virtue of the non-obstante clause, provisions of Chapter X-A of the ITA get an overriding effect over and above the other existing provisions of law.

SAAR

- Section 94 of the ITA deals with avoidance of tax by certain transactions in securities. Securities can be of different natures such as stocks, mutual funds, derivatives of non-recognized stock exchanges.
- At the relevant point of time, section 94(8) of the ITA dealt with only buying and acquiring of units³ within a period of three months prior to the record date.
- The taxpayer's contention that the SAAR, particularly, section 94(8) of the ITA, should take precedence over the GAAR, was fundamentally flawed and lacked consistency. The reason being the taxpayer's own assertion that section 94(8) of the ITA was not applicable to the shares at relevant time frame.

³ Securities was inserted under section 94(8) of the ITA by the Finance Act, 2022, w.e.f. 1 April 2023

- Further, section 94(8) may be relevant in a simple, isolated case of bonus share issue, provided such issuance has an underlying commercial substance. However, this provision did not apply to the case under consideration, as a bonus share issue was evidently an artificial avoidance arrangement lacking any logical or practical justification. The arrangement was primarily designed to sidestep tax obligations, in direct contravention of the principles of the ITA.

Judicial Anti-Avoidance Rules (JAAR)

- Before the formal codification of the GAAR into law in 2018, the judicial system had already established its own set of rules known as the JAAR. The JAAR operated under the principle of 'substance over form', essentially seeking to uncover misleading structures or transactional arrangements that lacked real commercial substance.
- These rules weren't arbitrary but carefully crafted tools, designed to scrutinize transactions and financial arrangements that might otherwise escape tax obligations through legal loopholes. Therefore, the JAAR used to ensure that all transactions were conducted transparently and within the spirit of the law.
- The legal amendments that followed were driven by the judiciary's firm commitment to uphold these anti-avoidance principles, using the power of law to enforce it. As a result, a new chapter, Chapter X-A, was added to the ITA.

Shome Committee Report

- The Committee's stance that SAAR should generally supersede GAAR mainly pertained to international agreements, not domestic cases. This stand, as per the report was further substantiated by the Finance Minister's declaration, made on 14 January 2013, that the applicability of either GAAR or SAAR would be determined on a case by-case basis.
- Subsequent introduction of Rule under section 95 and section 100 of the ITA indicate that Chapter X-A of the ITA could be used in conjunction with, or as a substitute for, other sections of the ITA. Further, the Finance Bill, 2013, only incorporated some of the expert committee's recommendations and Central Board of Direct Taxes (CBDT) also clarified that both GAAR and SAAR would be applied depending upon the specifics of each case.

Arrangement in the case under consideration

- The arrangement under consideration was being scrutinized as it was considered devoid of commercial substance, as per section 97 of the ITA. It was perceived as a deliberate misuse of the ITA's provisions, going beyond the intended use of the law. It created extraordinary rights and obligations that were not conducted in good faith. These unusual rights and obligations were not in line with the general principles of fair dealing, leading to the conclusion that it was an IAA under section 96 of the ITA.

Consequently, the arrangement fell under the purview of Chapter X-A.

- The SC in an earlier ruling⁴ implied that the business intent behind a transaction could serve as a strong piece of evidence that the transaction isn't a deceptive or artificial arrangement. The commercial motive behind a transaction often reveals the true nature of the transaction. However, the burden of proof was on the Revenue to prove any fiscal misconduct.
- In contrast, section 96(2) of the ITA places this responsibility on the taxpayer. It requires the taxpayer to disprove the presumption of a tax avoidance scheme. In the case under consideration, there was a clear and convincing evidence to suggest that the entire arrangement was intricately designed with the sole intent of evading tax. The taxpayer was not able to provide substantial and persuasive proof to counter the claim.

⁴ Vodafone International Holdings B.V. v. Union of India [2012] 17 taxmann.com 202 (SC)

In view of the above, the HC held that the transactions in the case under consideration were not permissible tax avoidance arrangements. Therefore, the provisions of Chapter X-A would become applicable.

Comments:

GAAR was introduced under Chapter X-A (sections 95 to 102) of the ITA with effect from 1 April 2017. Under GAAR, an arrangement entered into by the taxpayer may be declared to be an impermissible avoidance agreement by the tax authority and accordingly, the tax benefit may be denied. While GAAR covers all types of arrangement, SAAR covers specific type of transactions.

This ruling, while dealing with applicability of GAAR vis-à-vis SAAR, has held the following:

- By virtue of the non obstante clause under section 95(1) of the ITA dealing with the applicability of the GAAR, the provisions of Chapter X-A get overriding effect over and above the other existing provisions of law.
- The applicability of either GAAR or SAAR would be determined on a case by-case basis.
- The business intent behind a transaction could serve as strong evidence that the transaction isn't deceptive or artificial arrangement.

Separately, the HC also referred to earlier SC ruling in case of *Mc Dowell & Co. Ltd. v. Commercial tax Officer [1985] 22 Taxman 11 (SC)* and observed the following:

'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 honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.'

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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