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*By Electronic Delivery*

30 July 2012

Dr Parthasarthi Shome
Chairman
Expert Committee on GAAR
15th Floor, Hindustan Times Building
Kasturba Gandhi Marg
New Delhi - 110 001

RE: *General Anti-Avoidance Rule Draft Guidelines Provide Little Guidance*

Dear Committee for Implementation of GAAR:

The Investment Company Institute ("ICI")[1] and ICI Global[2] appreciate the steps taken by the Committee for Implementation of GAAR, in the draft GAAR guidelines, to address concerns we raised previously with provisions of the Finance Bill that could impact foreign investors negatively.[3] In particular, we support the change that shifts the burden of proof to the Indian Revenue Authorities and the GAAR's application only to income arising on or after 1 April 2013. Additionally, we welcome the recognition that Foreign Institutional Investors ("FIIs") should be afforded a safe harbor and that the GAAR should not be invoked against an FII's non-resident investors.

We remain extremely concerned, however, that the draft guidelines are so ambiguous, and that the relief provided is so narrow, that foreign investors will continue to face considerable uncertainties regarding the tax consequences of their Indian investments. Unless the guidelines are modified as we suggest, these ongoing uncertainties could impact investment decisions.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

[2] ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICIG manage total assets in excess of US $1 trillion.

[3] *See*, ICI/ICI Global letter to The Honorable Pranab Mukherjee, dated 3 April 2012.

Legal certainty is an essential requirement for robust and stable cross-border investment. Without such certainty, cross-border investors cannot judge adequately the relative benefits of Indian investments. Cross-border fund investors need certainty to calculate the daily net asset value ("NAV") of their shares; without an accurate NAV, mutual fund investors buying or selling shares at NAV will be paying or receiving too much, or too little, for their fund shares. This result is unacceptable from a business perspective and may create significant securities law issues as well.

The draft GAAR guidelines do not provide the certainty that cross-border fund investors need and that the Committee intended to provide. Two different causes of the uncertainty exist.

First, the examples often provide as "facts" what are actually conclusions. In one example, the "facts" discuss a company that "carries out business with *adequate* manpower, capital and infrastructure of its own and *therefore*, has *substantial* commercial substance (emphasis added)." No details are provided to illustrate the "*adequate"* manpower that was provided. In another example, the "facts" include a statement that a company located in a treaty country "does not have *substantive* commercial substance (emphasis added)." No details are provided to illustrate the level of substance required to prevent GAAR from being invoked.

Second, the draft guidelines do not illustrate the applicability of these factors to fund structures. Unlike corporate affiliates, a fund typically does not have employees; instead, all investment management activities and administrative services are provided by a fund's asset manager (or third-party service providers hired by the asset manager). Providing appropriate and certain tax results to funds' cross-border investments requires revising the examples to account for these characteristics of fund structures.

Cross-border investors need guidelines that provide facts rather than conclusions and that illustrate the GAAR's application to fund structures. Investments in India's future cannot be made with confidence unless cross-border investors have the certainty we request. The guidelines need to *illustrate* when "one of the main purposes" of an arrangement is to obtain a tax benefit; the guidelines need to *illustrate* when an arrangement is a "misuse/abuse of tax provisions;" the guidelines need to *illustrate* when an arrangement "lacks commercial substance;" the guidelines need to *illustrate* when the arrangement is "not ordinarily employed for bona fide purposes." The draft guidelines do not provide the necessary illustrations.

We urge that the guidelines be revised promptly to provide cross-border investors with the certainty they need to be confident in the tax treatment of their investments in India. After revision, the draft guidelines should be released for further comment.

To the extent that certain types of investors, or the residency requirements of any specific country with which India has an income tax treaty, are viewed as problematic, narrowly-crafted solutions (such as a specific anti-avoidance rule or SAAR) should be advanced. Such narrowly-crafted

solutions could include a strict and well-negotiated limitation of benefits test in tax treaties. Our April 2012 letter urged the adoption of narrowly-crafted solutions. The draft guidelines provide further evidence that narrowly-crafted solutions, rather than broad and undefined rules, are preferable.

We also continue to urge that any change from existing law apply only prospectively, after a transition period, to new investments. Changing the tax treatment of an investment after it has been made does not promote the investor confidence necessary to ensure a robust cross-border demand for Indian securities.

* * *

While the draft guidelines are a promising start, the uncertainty posed by potential applications of the GAAR continues to erode investor confidence in the Indian capital markets and to impact negatively the investor demand for Indian securities. The draft guidelines should be revised to illustrate more precisely how the GAAR will be administered and how it will be applied to investment structures; the revised draft guidelines then should be released for further public comment. Moreover, narrowly-crafted solutions (such as a SAAR) should be advanced to address specific problems. Finally, any change that GAAR makes to investors' settled expectations should apply only prospectively to new investments. The GAAR should not be applied to existing investments that often were made based upon pronouncements by the Indian tax authorities or the Indian courts.

We appreciate greatly your attention to this serious matter. If there is any additional information that we can provide, please contact me (at lawson@ici.org or 001-202-326-5832).

Sincerely,

*/s/ Keith Lawson*

Keith Lawson
Senior Counsel – Tax Law

cc: R.S. Gujral, Finance Secretary/Revenue Secretary, Ministry of Finance
Sunil Gupta, Joint Secretary, Tax Policy and Legislation, Department of Revenue
U.K. Sinha, Chairman, Securities and Exchange Board of India

**Draft guidelines regarding implementation of General Anti Avoidance Rules (GAAR) in terms of section 101 of the Income Tax Act, 1961.**

## Background

The Chairman, CBDT, Vide OM F.NO. 500/111/2009-FTD-1 Dated 27 February, 2012 constituted a Committee under the Chairmanship of the Director General of the Income Tax (International Taxation) to give recommendations for formulating the guidelines for proper implementation of GAAR Provisions under the Direct Tax Code Bill, 2010 and to suggest safeguards to these provisions to curb the abuse thereof. The Committee comprised of the following officers :-

1. Director General of Income Tax (International Taxation)- Chairperson
2. Joint Secretary (FT& TR-I)
3. Joint Secretary (FT& TR-II)
4. Joint Secretary (TPL-I)
5. Director of International Taxation, Ahmedabad
6. Director, FT & TR-III
7. Addl. Director on Income Tax, Range-I (IT), New Delhi, Member Secretary.

The terms of reference of the Committee was as under :-

a) Recommendations for formulating guidelines to implement the provisions of General Anti-Avoidance Rules(GAAR) as per section 123 of the Direct Tax Code Bill, 2010; and

b) Draft a circular as a safeguard so that the GAAR provisions are not applied indiscriminately in every case.

The Committee met for the first time on 6th March, 2012 and felt that the existing provisions of the Direct Tax Code Bill 2010(DTC) needed certain modifications and therefore various specific suggestions were made in this regard. These included suggestions on defining various terms as appearing in the DTC, changing the procedure of invoking the provisions of GAAR, prescribing time limits etc.

Subsequent to the first meeting, the Finance Bill 2012 was presented before the Parliament and it was gathered that most of the suggestions given in the first meeting were addressed in the Finance Bill 2012. The Committee thereafter examined the provisions related to GAAR in the Finance Bill 2012 as modified through Government amendments during the passage of the Bill in Parliament. The recommendations regarding guidelines/circulars have been made in light of the final provisions relating to GAAR in the Finance Act, 2012.

The Committee held several meetings between 06.03.2012 to 28.05.2012.

After exhaustive deliberations and broad based discussions with the officers, representatives of FII's, members of the advisory committee and others stake holders, the Committee makes the following recommendations which would need to be split between Circulars and the Rules.

## Proposals for inclusion in the guidelines

### A) Guidelines u/s 101

Section 101 of the Finance Act, 2012, provides that "the provisions of this Chapter shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed". The Committee makes the following recommendations to be incorporated in the guidelines.

#### a) Monetary threshold

The committee feels that in order to avoid the indiscriminate application of the GAAR provisions and to provide relief to small taxpayers, there should be monetary threshold for invoking the GAAR provisions. In this regard, the following recommendation is made by the committee.

***Only an arrangement or arrangements where the tax benefit through the arrangement(s) in a year to an assessee is above Rs. ___ lacs will be covered by GAAR provisions.***

#### b) Prescription of statutory forms

The committee feels that consistency of approach is essential in the procedures for invoking the GAAR provisions. It also feels that adequate safeguards should be provided to ensure that principles of natural justice were not violated and there is transparency in the procedures. Therefore, the committee is of the opinion that there should be prescribed statutory forms for the following:-

i) ***For the Assessing Officer to make a reference to the Commissioner u/s 144BA(1) (Annexure-A)***

ii) ***For the Commissioner to make a reference to the Approving Panel u/s 144BA(4) (Annexure-B)***

iii) ***For the Commissioner to return the reference to the Assessing Officer u/s 144BA(5) (Annexure-C)***

(The drafts thereof have been prepared and enclosed as above)

## c) Prescribing the time limits

The committee feels that there should be absolute certainty about the time limits during which the various actions under the GAAR provisions are to be completed. Some of these time lines have been prescribed under the act under sections 144BA(1) and 144BA(13). For the remaining actions the following time lines are suggested by the committee :-

***It may be prescribed that in terms of section 144BA(4), the CIT should make a reference to the Approving Panel within 60 days of the receipt of the objection from the assessee and in case of the CIT accepting the assessee's objection and being satisfied that provision of chapter X-A are not applicable, the CIT shall communicate his decision to the AO within 60 days of the receipt of the assessee's objection as prescribed under section 144BA(4) r.w.s. 144BA(5). No action u/s 144BA(4) or (5) shall be taken by the Commissioner after the period of six months from the end of the month in which the reference under sub-section 144BA(1) was received by the Commissioner.***

## B) Recommendations regarding setting up of the Approving Panel u/s 144(BA)

Section 144BA(14) has empowered the CBDT to constitute Approving Panel consisting of not less than 3 members, out of which one member of the panel would be an officer of the level of Joint Secretary or above from the Ministry of Law and the others being the Income Tax Authorities of the rank of Commissioner and above. The committee deliberated on the constitution of this committee for efficient output and has made the following recommendations :-

**(a) To begin with, there should be one Approving Panel, which shall be situated at Delhi. Subsequently, the CBDT should review the number of Approving Panels required on the basis of the workload in the FY 2014-15.**

**(b) The Approving Panel should comprise of three members, out of which, two members should be of the level of Chief Commissioners of Income Tax and the third member should be an officer of the level of Joint Secretary or above from the Ministry of Law. All the members should be full time members.**

**(c) The Approving Panel should be provided the secretariat staff along with appropriate budgetary and infrastructure support by the CBDT. The secretariat should be headed by an officer of the level of Joint/Additional Commissioner of Income Tax.**

## C) Recommendations for the Circular on GAAR

### a) Explaining the provisions of GAAR

For the purpose of explaining the provisions of GAAR and better understanding thereof, the Committee suggests a detailed note to be included in the circular, which is enclosed as **Annexure- D**.

### b) Special provisions for Foreign Institutional Investors (FII's)

Foreign Institutional Investors have expressed certain concerns regarding GAAR provisions. The committee met the representatives of Asia Securities Industry & Finance Markets Association and Capital Markets Tax Committee of Asia. After discussions, the representatives of these bodies gave following suggestions to resolve their apprehensions.

1. To exempt Capital Market transactions entirely from the GAAR provisions
2. A flat tax on FII's gains without any distinction between various transactions could be considered.
3. The tax authorities could attempt to clarify the details of each provision in the GAAR. For this, they gave comments on how the relevant provision may be clarified.

   The committee considered the suggestions of the representatives. Option No. (1) & (2) above are not viable options as it is not permitted under the provisions of the Income Tax Act. However option (3) could be considered. For this purpose, safe harbour could be provided to the FII's subject to the payment of taxes as per domestic law. Accordingly, the committee recommends the following.

***Where a Foreign Institutional Investor (FII) chooses not to take any benefit under an agreement entered into by India under section 90 or 90A of the Act and subjects itself to tax in accordance with the domestic law provisions, then, the provisions of Chapter X-A shall not apply to such FII or to the non-resident investors of the FII.***

***Where an FII chooses to take a treaty benefit, GAAR provisions may be invoked in the case of the FII, but would not in any case be invoked in the case of the non-resident investors of the FII.***

**c)** Clarity regarding retrospective/prospective operations of the GAAR provisions

Certain apprehensions have been raised regarding the retrospective/prospective operation of the GAAR provisions. It may therefore be clarified that :-

***The provisions of GAAR will apply to the income accruing or arising to the taxpayers on or after 01.04.2013.***

**d)** Interplay between Specific Anti-Avoidance Rules (SAAR) and General Anti-Avoidance Rules (GAAR).

Concerns have been raised that there could be interplay between the SAAR and GAAR. The committee examined this issue and the recommendation of the committee is as below:-

***While SAARs are promulgated to counter a specific abusive behavior, GAARs are used to support SAARs and to cover transactions that are not covered by SAARs. Under normal circumstances, where specific SAAR is applicable, GAAR will not be invoked. However, in an exceptional case of abusive behavior on the part of a taxpayer that***

***might defeat a SAAR, as illustrated in Example No. 16 in Annexure E (or similar cases), GAAR could also be invoked.***

**e)** Definition of "connected person"

Concerns have been raised that the definition of "connected person" u/s 102 (5) is too broad and ambiguous. The committee recommends that it may be clarified that:-

***"Connected person" would include the definition of "associated enterprise" given in section 92A, the definition of 'relative' in section 56 and the "persons" covered u/s 40A(2)(b).***

**f)** Concern regarding application of section 96(2)

Concerns have been raised in various fora that section 96(2) provides that an arrangement shall be presumed 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. In view of this provision where only a part of the arrangement is to obtain a tax benefit, the tax authorities will treat the whole arrangement as an impermissible arrangement.

In order to allay the apprehensions of the taxpayers in this regard, the committee recommends that it must be clarified in the Rules that :-

***Where only a part of the arrangement is impermissible, the tax consequences of "Impermissible Avoidance Arrangement" will be limited to only that part of the arrangement.***

## g) Illustrative cases under GAAR

The committee felt that terms like, “Misuse or abuse”, “bona fide purpose” and “lacks commercial substance” may be explained by illustrations. However it may be clarified that it should be only an indicative list and not an exhaustive list. The committee has recommended a few illustrative cases, which are given in **Annexure-E**. The guidelines provided through examples are based on specific facts in the particular example. Whether GAAR may be invoked in any particular case would depend on the specific facts of that case.

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*Annexure-A*

**FORM FOR MAKING THE REFERENCE TO THE COMMISSIONER BY THE ASSESSING OFFICER FOR INITIATING THE PROCEEDINGS U/S 144BA(1) rws 95 OF THE INCOME TAX ACT, 1961**

| | | |
|---|---|---|
| 1 | Name and Address of the Assessee | |
| 2 | PAN | |
| 3 | Status | |
| 4 | Particulars of Assessing Officer | |
| 5 | Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked :<br>(a) Assessment Years pending in scrutiny<br>(b) Other assessment years proposed to be covered | |
| 6 | Provide a factual matrix of the "arrangement" entered into by the assessee | |
| 7 | Is there any "Tax Benefit" as defined in section 102(11) ? | |
| 8 | If yes, provide the approximate quantum thereof assessment year wise. | |
| 9 | Is "Tax Benefit" the "main purpose" or one of the "main purposes" of the "arrangement" ? | |
| 10 | Brief facts of the "Tax Benefit" | |
| 11 | Has the assessee been confronted with the details of the "Tax Benefit"? If yes, provide the gist of the reply furnished by the assessee on "Tax Benefit" | |
| 12 | If "Tax Benefit" is the "main purpose" or one of the "main purposes" specify which other condition, out of the following is satisfied giving details how the conclusion has been arrived at:<br>(a) Creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;<br>(b) Results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;<br>(c) Lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or<br>(d) Is entered into, or carried out, by means, or in manner, which are not ordinarily employed for bona fide purposes. | |
| 13 | Has the assessee been confronted with the findings given in column 12 ? If yes, provide the gist of the reply furnished by the assessee. | |
| 14 | Detailed reasons for treating the arrangement as "Impermissible Avoidance arrangement". | |
| 15 | Consequences likely to arise if arrangement is declared as "Impermissible Avoidance arrangement" | |
| 16 | Specify the time barring dates of original assessment or reassessment | |

Date: Name & Designation of
Place: Assessing Officer

*Annexure-B*

**FORM FOR RECORDING THE SATISFACTION BY THE COMMISSIONER OF INCOME TAX FOR REFERRING THE PROCEEDINGS U/S 144BA(4) rws 95 OF THE INCOME TAX ACT, 1961 TO THE APPROVING PANEL**

| | | |
|---|---|---|
| 1 | Name and Address of the Assessee | |
| 2 | PAN | |
| 3 | Status | |
| 4 | Particulars of Assessing Officer | |
| 5 | Particular of Commissioner of Income Tax | |
| 6 | Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked :<br>(a) Assessment Years pending in scrutiny<br>(b) Other assessment years proposed to be covered | |
| 7 | Date of receipt of reference from the AO u/s 144BA (1) | |
| 8 | Date of issuance of notice, setting out reasons, by the CIT to the assessee (copy thereof to be enclosed) | |
| 9 | Date of receipt of reply from the assessee and date of hearing provided to the assessee (copy of reply of the assessee to be enclosed) | |
| 10 | Provide a factual matrix of the "arrangement" entered into by the assessee | |
| 11 | Is there any "Tax Benefit" as defined in section 102(11) ? | |
| 12 | If yes, provide the approximate quantum thereof assessment year wise. | |
| 13 | Is "Tax Benefit" the "main purpose" or one of the "main purposes" of the "arrangement" ? | |
| 14 | Brief facts of the "Tax Benefit" | |
| 15 | Has the assessee been confronted with the details of the "Tax Benefit" ? If yes, provide the gist of the reply furnished by the assessee on "Tax Benefit" | |
| 16 | If "Tax Benefit" is the "main purpose" or one of the "main purposes" specify which other condition, out of the following is satisfied giving details how | |

| | | |
|---|---|---|
| | the conclusion has been arrived at:<br>(a) Creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;<br>(b) Results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;<br>(c) Lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or<br>(d) Is entered into, or carried out, by means, or in manner, which are not ordinarily employed for bona fide purposes. | |
| 17 | Has the assessee been confronted with the findings given in column 16? If yes, provide the gist of the reply furnished by the assessee. | |
| 18 | Detailed reasons for treating the arrangement as "Impermissible Avoidance arrangement". | |
| 19 | Consequences likely to arise if arrangement is declared as "Impermissible Avoidance arrangement" | |
| 20 | Specify the time barring dates of original assessment or reassessment | |

Date: Name & Designation of

Place: Commissioner of Income Tax

*Annexure-C*

**FORM FOR RETURNING THE REFERENCE U/S 144BA(5) rws SECTION 95 IN CASES OF REFERENCES MADE U/S 144BA(4) rws 95 OF THE INCOME TAX ACT, 1961 TO THE ASSESSING OFFICER**

| | | |
|---|---|---|
| 1 | Name and Address of the Assessee | |
| 2 | PAN | |
| 3 | Status | |
| 4 | Particulars of Assessing Officer | |
| 5 | Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked. | |
| 6 | Date of receipt of reference from the AO u/s 144BA (1) | |
| 7 | Reasons for not agreeing with the reference from the AO u/s 144BA (1) | |

Date: Name & Designation of

Place: Commissioner of Income Tax

*Annexure-D*

# GAAR – Note for Guidelines

1.0 While introducing the provisions of General Anti Avoidance Rule (GAAR) in the Income-tax Act, it was mentioned in the Explanatory Memorandum to the Finance Bill, 2012 that the question of substance over form has consistently arisen in the implementation of taxation laws. In the Indian context, judicial decisions have varied. While some courts in certain circumstances had held that legal form of transactions can be dispensed with and the real substance of transaction can be considered while applying the taxation laws, others have held that the form is to be given sanctity. There are some specific anti-avoidance provisions, but, prior to introduction of GAAR, general anti-avoidance has been dealt in specific cases only through judicial decisions. In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning. Internationally, several countries have codified the "substance over form" doctrine in the form of General Anti Avoidance Rule (GAAR) and are administering statutory GAAR provisions.

1.1 The General Anti Avoidance Rule (GAAR) is a codification of the proposition that while interpreting the tax legislation, substance should be preferred over the legal form. Transactions have to be real and are not to be looked at in isolation. The fact that they are legal does not mean that they are acceptable with reference to the meaning in the fiscal statute. Where there is no business purpose, except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have otherwise been part of jurisprudence in direct tax laws as reflected in various judicial decisions. The GAAR provisions codify this 'substance' over 'form' rule.

1.2 The basic criticism of a statutory GAAR which is raised worldwide is that it provides a wide discretion and authority to the tax administration which can cast an excessive tax and compliance burden on the taxpayer without commensurate remedies. One of the methods by which this can be addressed is to provide guidance on what the provisions entail and how they would be administered. These guidelines are meant to provide explanations and clarity regarding the GAAR provisions.

## 2. Tax avoidance vs Tax Evasion

2.1 Tax evasion is generally the result of illegality, suppression, misrepresentation and fraud. Tax avoidance is the result of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law itself. The GAAR provisions do not deal with cases of tax evasion. Tax evasion is clearly distinct from tax avoidance and is already prohibited under the current provisions of the Income-tax Act.

## 3. Tax avoidance vs Tax mitigation

3.1 'Tax mitigation' is a situation where the taxpayer takes advantage of a fiscal incentive afforded to him by the tax legislation by actually submitting to the conditions and economic consequences that the particular tax legislation entails. An example of tax mitigation is the setting up of a business undertaking by a taxpayer in a specified area such as a Special Economic Zone (SEZ). In such a case the taxpayer is taking advantage of a fiscal incentive offered to him by submitting to the conditions and economic consequences of the SEZ provisions in the Income-tax Act e.g., setting up the business only in the SEZ areas and export from the SEZ area. Tax mitigation, as distinct from tax avoidance, is allowed under the tax statute. The GAAR provisions also do not deal with case of tax mitigation.

## 4. Analysis of the GAAR provisions

4.1 The provisions relating to GAAR appear in Chapter X-A (sections 95 to 102) of the Act. The provisions allow the tax authority to, notwithstanding anything contained in the Act, declare an 'arrangement' which the assessee has entered into, as an 'impermissible avoidance arrangement'. Once an 'arrangement' has been declared as an 'impermissible avoidance arrangement', the consequence as regards the tax liability would also be determined.

4.2 The provisions give a wide definition of the term 'arrangement'. An 'arrangement' means any step in or a part or whole of any transaction, operation, scheme, agreement or understanding, whether enforceable or not. It also includes the alienation of any property in such a transaction etc. **The onus of proving that there is an impermissible avoidance arrangement is on the Revenue.**

4.3 An 'arrangement' would be an 'impermissible avoidance arrangement' if,

(a) its main purpose is to obtain a 'tax benefit', and,

(b) it also has one of the following characteristics:

- (i) it creates rights and obligations, which are not normally created between parties dealing at arm's length;
- (ii) it results in misuse or abuse of the provisions of the tax law;
- (iii) it lacks commercial substance;
- (iv) it is carried out by means or in a manner which is normally not employed for an authentic (*bona fide)* purpose.

A 'tax benefit' has been defined to mean

(i) a reduction or avoidance or deferral of tax or other amount payable under the Act or as a result of a tax treaty;

(ii) an increase in a refund of tax or other amount that would be payable under the Act or as a result of tax treaty; or

(iii) a reduction in total income including an increase in loss.

The term "tax benefit" would be the benefit, quantified in terms of tax liability, arising to any party to the arrangement on account of such arrangement.

4.4 **The onus of proving that**

**(A) there is an arrangement,**

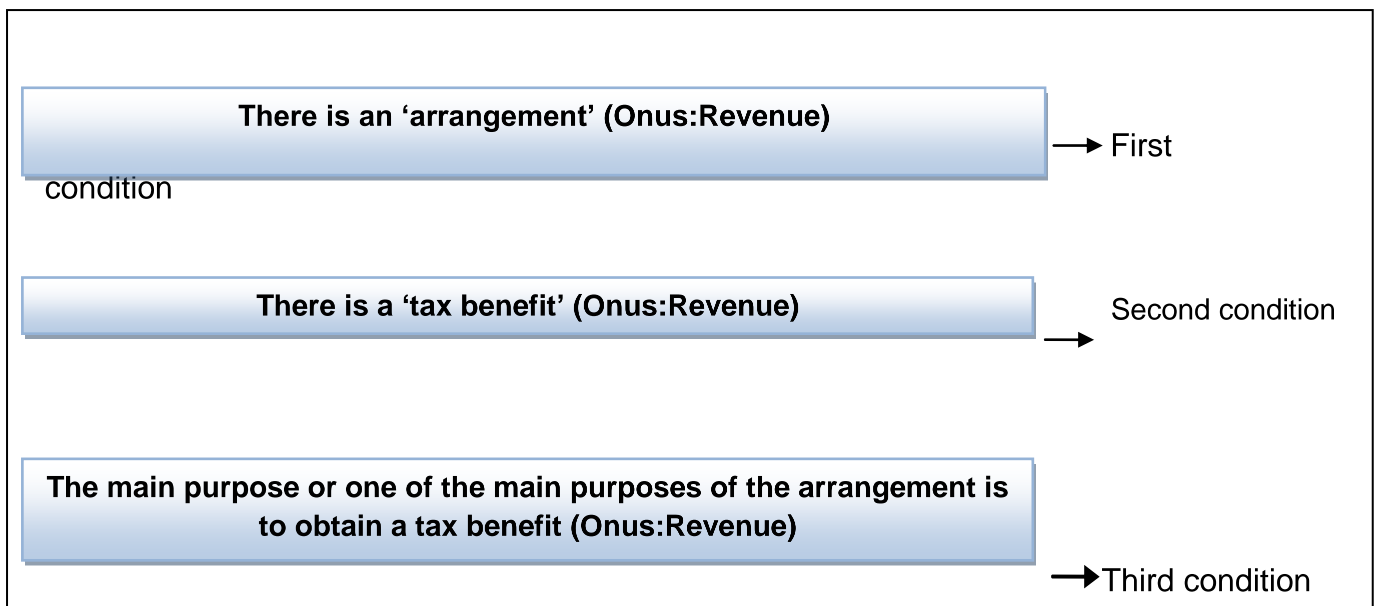
**(B) the arrangement leads to a 'tax benefit',**

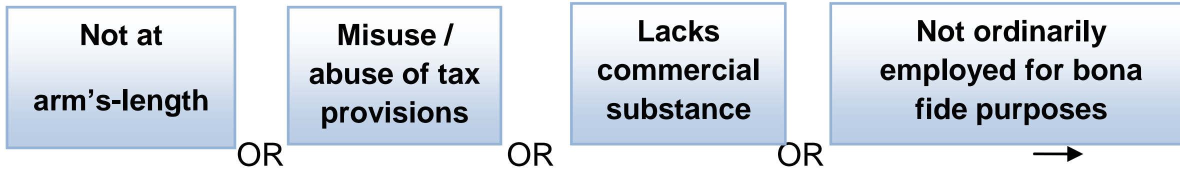
**(C) the main purpose or one of the main purposes of the 'arrangement' is to obtain a 'tax benefit', and**

**(D) the arrangement has one of the characteristics listed at (i) to (iv) at (b) of 4.3 above**

**is on the revenue.**

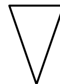
## 5. Flow chart of GAAR provisions





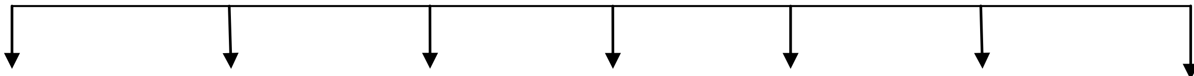

Fourth condition

(**Onus : Revenue**)



**Impermissible Avoidance Arrangement**

**Consequences may be determined by***



| Dis-regarding/ Combining/ recharacterising whole/ part of the imper-missible | Treating the imper-missible arrangement as if it had not been carried out | Dis-regarding any accommodating party or treating them and any other party as one and the same | Treating connected parties as one and the same person | Re-allocating accruals, expenses etc. | Treating place of residence, situs of assets or of transac-tion different from that provided in the | Looking through an arrangement by dis-regarding corpo-rate structure |
|---|---|---|---|---|---|---|

** For this purpose equity, debt, expenses, accrual or receipt, relief or rebate may be re-characterised.*

*Annexure-E*

## Illustrative cases where GAAR provisions will be considered applicable or not applicable

### *Example 1:*

**Facts:**

A business sets up an undertaking in an under developed area by putting in substantial investment of capital, carries out manufacturing activities therein and claims a tax deduction on sale of such production/manufacturing. Is GAAR applicable in such a case ?

**Interpretation:**

There is an arrangement and one of the main purposes is a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by submitting to the conditions and economic consequences of the provisions in the legislation e.g., setting up the business only in the under developed area. Revenue would not invoke GAAR as regards this arrangement.

### *Example 2:*

**Facts:**

A business sets up a factory for manufacturing in an under developed tax exempt area. It then diverts its production from other connected manufacturing units and shows the same as manufactured in the tax exempt unit (while doing only process of packaging there). Is GAAR applicable in such a case ?

**Interpretation:**

There is an arrangement and there is a tax benefit, the main purpose or one of the main purposes of this arrangement is to obtain a tax benefit. The transaction lacks commercial substance and there is misuse of the tax provisions. Revenue would invoke GAAR as regards this arrangement.

### *Example -3* :

**Facts:**

A foreign investor has invested in India through a holding company situated in a low tax jurisdiction 'X'. The holding company is doing business in the country of incorporation, i.e. 'X', has a Board of Directors that meets in that country and carries out business with adequate manpower, capital and infrastructure of its own and therefore, has substantial commercial substance in the said country 'X'. Would GAAR be invocable or would the arrangement be permissible ?

**Interpretation:**

In view of the factual substantive commercial substance of the arrangement, Revenue would not invoke the GAAR provisions.

### *Example -4:*

***Facts:***

An Indian company has set up a holding company in a low tax jurisdiction outside India which has set up further subsidiary companies which pay dividends to the holding company and such dividends are not repatriated to the Indian company. Would the deemed dividend be treated as income using GAAR?

**Interpretation:**

Declaration/repatriation of dividend is a business choice of the companies and GAAR provisions would not apply. Based on further facts such as the degree of Indian Ownership, the location of the subsidiaries (in low tax jurisdictions) and the nature of income (most of the income being passive income like interest, dividend etc.), many jurisdictions have anti-deferral and avoidance provisions in the form of Controlled Foreign Company (CFC) provisions. Specific anti-deferral/anti-avoidance provisions is proposed in the Direct Taxes Code Bill, 2010. Accordingly, GAAR would not be invoked in such a case.

### *Example -5:*

***Facts:***

The merger of a loss making company into a profit making one results in losses off setting profits, a lower net profit and lower tax liability for the merged company. Would the losses be disallowed under GAAR ?

**Interpretation:**

As regards setting off of losses, the provisions relating to merger and amalgamation already contain specific anti-avoidance safeguards and therefore, GAAR would not be invoked.

***Example -6:***

***Facts:***

A choice made by a company between leasing an asset and purchasing the same asset. The company would claim deduction for leasing rentals rather than depreciation if it had their own asset. Would the lease rent payment be disallowed as expense under GAAR ?

**Interpretation:**

GAAR provisions, would not, prima facie, apply to a decision of leasing (as against purchase of an asset). However, if it is a case of circular leasing, i.e. the taxpayer leases out an asset and through various sub-leases, takes it back on lease, thus creating a tax benefit without any change in economic substance, Revenue would examine the matter for invoking GAAR provisions.

***Example -7:***

***Facts:***

A company has raised funds from an unconnected party through borrowings, when it could have issued equity. Would the interest be denied as an expense deduction under GAAR ?

**Interpretation:**

A number of jurisdictions have specific thin capitalization rules to deter erosion of the tax base through excessive interest payments. There is no specific provision dealing with this (thin-capitalization) in the I.T. Act. An evaluation of whether a business should have raised funds through equity instead of as a loan should generally be left to commercial judgment and GAAR would not be attracted. Interest payments to connected parties would be subject to transfer pricing provisions. However, based on whether the payments are made to connected parties, the source of funds in the case of the connected parties and the location of these connected parties in low tax jurisdictions, the arrangement could be examined under GAAR provisions.

### *Example -8:*

***Facts:***

A large corporate group has created a service company to manage all its non core activities. The service company then charges each company for the services rendered on a cost plus basis. Can the mark up in the cost of services be questioned using GAAR.

**Interpretation:**

There are specific anti avoidance provisions through transfer pricing as regards transactions among related parties. GAAR will not be invoked.

### *Example -9:*

***Facts:***

A company sets off losses in the stock market against gains which is aimed at balancing the portfolio.

**Interpretation:**

Sale/purchase through stock market transactions where the buyer and seller are anonymous to each other would not come under GAAR provisions. GAAR provisions could be invoked based on specific facts where transactions are not anonymous i.e. parties are related to each other or a transaction has been entered into through a pre-arrangement between unrelated parties who have been brought together by an intermediary like a broker in order to adjust profit and losses between themselves.

### *Example -10:*

**Facts**

'Y' company, a non- resident, and 'Z' company, a resident of India, form a joint venture company 'X' in India. 'Y', incorporates a 100%subsidiary 'A' in country ABC of which 'Y' is not a resident. The India-ABC tax treaty provides for non-taxation of capital gains in the source country and country ABC charges a minimal capital gains tax in its domestic law. 'A' is also designated as a "permitted transferee" of Y. "Permitted transferee" means that though shares are held by 'A', all rights of voting, management, right to sell etc., are vested in 'Y'. As provided by the joint venture agreement, 49% of X`s equity is allotted to company 'A' (being 100% subsidiary and "permitted transferee" of 'Y') and the remaining 51% is allotted to the 'Z' company. Thereafter, the shares of 'X' held by 'A' are sold by 'A' to 'C' (connected to the 'Z' group).

**Interpretation**

The controlling rights of company 'A' were with 'Y'. A direct transfer of these shares by company 'Y' to company 'C' would have attracted capital gains tax in India read with the relevant treaty of Y's country of residence. The company 'A' was interposed with main purpose of taking advantage of India-ABC treaty. The arrangement results in misuse or abuse of tax provisions. Revenue would invoke GAAR as regards this arrangement.

### *Example -11:*

**Facts**:

Company 'A', is incorporated in country ABC as a wholly owned subsidiary of company 'B' which is not a resident of ABC or of India. The India-ABC tax treaty provides for non-taxation of capital gains in the source country and country ABC charges a minimal capital gains tax in its domestic law. Some shares of an Indian Company 'C' were acquired by 'A'. The entire funding for investment by 'A' in 'C' was done by 'B'. 'A' has not made any other transaction. These shares were subsequently disposed of by 'A', thus resulting in capital gains which 'A' claims as not being taxable in India by virtue of the India- ABC tax treaty.

**Interpretation**:

The beneficial ownership vests with the connected company 'B' which had played a crucial role in the transaction conducted by 'A'. Though the legal ownership ostensibly resides with the 'A', the real and beneficial owner of the capital gains is the 'B' Company which controls the connected company 'A'. This is an arrangement which has been created with the main purpose of avoiding capital gains tax in India through misuse or abuse of tax provisions. Hence it is impermissible arrangement. Revenue would invoke GAAR as regards this arrangement.

### *Example -12:*

**Facts**:

An Indian Company 'A', is a closely held company and its major shareholders are connected companies 'B' ,'C' and 'D'. 'A' was regularly distributing dividends but stopped distributing dividends from 1.4.2003, the date when Dividend Distribution Tax (DDT) was introduced in India. 'A' allowed its reserves to grow by not paying out dividends. As a result no DDT was paid by the company. Subsequently, all its shareholders buyback of shares was offered by the Indian Company 'A' to its shareholder company 'B' based in country ABC and the other shareholders C and D

who are not resident of ABC. The India-ABC tax treaty provides for non-taxation of capital gains in the source country and country ABC charges very low capital gains tax in its domestic law. The buyback offer was only accepted by the entity B. The accumulated reserves of A were used to buyback the shares from the B entity.

**Interpretation**:

The arrangement is a colourable device designed to avoid tax in India. No dividends were distributed by A since 1.4.2003, the day the Dividend Distribution Tax was implemented for non bona fide purpose. Thus 'A' obtained tax benefit by not declaring dividend and passing this on as exempt capital gain in the hands of connected company B. The buyback of shares was accepted onlyby connected company B and not by the connected companies C and D as they would have invited capital gains tax by accepting such offer. Revenue would invoke GAAR as regards this arrangement.

### *Example -13:*

**Fact**:**s**

The Shares of 'V', an asset owning Indian company, was held by an Indian Company 'X'. 'X' was in turn held by two companies 'E' and 'C', incorporated in country ABC. The India-ABC tax treaty provides for non-taxation of capital gains in the source country and country ABC charges very low capital gains tax in its domestic law. The Company 'X' was liquidated by consent and without any Court Decree. This resulted in transfer of the asset/shares from company 'X', to companies 'E' and 'C'. Subsequently companies 'E' and 'C' sold the shares to 'A' which was incorporated in country ABC. The companies 'E' and 'C' claimed benefit of tax treaty and the resultant gain of the transaction was claimed not to be taxable.

**Interpretation:**

The chain of events bring out the fact that the asset that was situated in India and held by an Indian Company was transferred by liquidation of the Indian Company by an arrangement so as to misuse or abuse the tax provisions . Revenue would invoke GAAR as regards this arrangement.

### *Example -14:*

**Facts**

A foreign bank 'F's branch in India arranges loan for Indian borrower from 'F' bank's branch located in a third country. The loan is later assigned to 'F' bank's branch in XYZ country to take benefit of withholding provisions of India-XYZ treaty (India-XYZ Treaty provides no source based withholding tax on interest to a bank carrying out bona-fide business.)

**Interpretation**

Since there is no withholding provision on interest earned by XYZ residents under the India-XYZ treaty, the above arrangement of finalizing the loan from one country and assigning it to another country has been made to avoid withholding provisions. This is a misuse of tax treaty and thus will be treated as an "impermissible avoidance arrangement". Revenue would invoke GAAR with regard to this arrangement.

### *Example -15:*

**Facts**

Under the provisions of a tax treaty between India and country XYZ, any capital gains arising from the sale of shares of an Indian company would be taxable only in XYZ, if the transferor is a resident of XYZ. There is further provision condition under the treaty that gains from alienation of shares issued by an Indian company wherein for more than an interest of XYZ in the capital stock of that Indian company can be taxed in India. A company resident in XYZ owns more than X % shareholding in an Indian Company. It sells shares of that Indian Company (being less than X % interest each at short intervals thus, cumulatively transferring more than "X"%. It thus escapes liability for capital gains tax in India even though it owns more than X% interest in the Indian company.

**Interpretation**

The above arrangement of splitting the same transaction into many transactions at short intervals below the threshold limit could amount to abuse of tax laws and deemed to be lacking commercial substance and hence would be an "impermissible avoidance arrangement". Revenue would invoke GAAR with regard to this arrangement.

### *Example -16:*

**Facts:**

Company 'A' is a non resident company in country R and is wholly owned by company 'X' in country T. Company 'X' is a financial company with substantial reserves and looking for investments in India. Company 'X uses its subsidiary company 'A' to route its investment in an Indian company 'B' whereby company 'A' purchases the shares of company 'B'. After sometime, company 'A' sells the shares of company 'B' to another company 'C' and realizes capital gains. As per the provisions of relevant DTAA Protocol between country R and India, a shell/conduit company is not eligible for capital gains exemption in India. However, a company shall not be deemed to a shell/conduit company if its total annual expenditure on operations in country R is equal to or more than Rs. 1,00,00,000/- in the immediately preceding period of 24 months from the date the gains arise. Company 'A' claims that capital gains are not taxable in India as it is not a shell company as per the relevant DTAA Protocol and that it incurred Rs. 1,20,00,000/- (Rs. 40,00,000/- as license fees and local office expenses, Rs. 80,00,000/- as interest payments to 'X' company, its parent holding company) as business expenses as per P&L A/C to show its economic presence in country 'R' as it claimed expenditure exceeding the limit prescribed therein and for it not to be shell/conduit company.

**Interpretation:**

Company 'A' has incurred only Rs. 40,00,000/- on operations in country 'R'. Interest payments of Rs. 80,00,000/- outside country 'R' cannot be taken into account for the purposes of computation of Rs. 1,00,00,000/- limit of expenses incurred on operations in country 'R'. Company 'A' will be deemed to be a shell/conduit company. The treaty benefit may be denied under LOB clause of the treaty itself. As it is an arrangement for claiming benefits of DTAA and it lacks economic substance, therefore, Revenue may also invoke GAAR with regard to this arrangement.

### *Example -17:*

**Facts:**

An Indian company is in the business of import and export of certain goods. It purchases goods from Country A and sells the same in country B. It sets up a subsidiary in Country X - a zero/ low tax jurisdiction. The director of the Indian company finalizes the contracts in India but shows the documentation of the purchase and sale in Country X. The day to day management operations are carried out in India. The goods move from A directly to B. The transactions are recorded in the books of subsidiary in country X, where the profits are tax exempt.

**Interpretation:**

A company is camouflaging the sale and purchase transactions as X country based transactions. By this arrangement, the Indian company has obtained a tax benefit. The substance or effect of the arrangement as a whole is inconsistent with, or differs significantly from, the forms of its individual steps and hence, lacks commercial substance. Revenue would invoke GAAR with regard to this arrangement.

### *Example -18:*

**Facts:**

A company ‘A’ in country ‘X’ invests in a company ‘B’ situated in country ‘R’. Country ‘R’ has a provision of residence based taxation of capital gains in its tax treaty with India. ‘B’ further invests the funds in equities in India and earns capital gains. ‘B’ does not have substantive commercial substance in country ‘R’.

**Interpretation:**

If ‘A’ invests directly in India, it does not get benefit of treaty and has to pay capital gains tax in India. By routing the funds through ‘B’ in country ‘R’, the payment of capital gains tax in India has been avoided. This is an impermissible avoidance arrangement and revenue would invoke GAAR with regard to this arrangement.

### *Example -19:*

**Facts**

An employee of a private limited company ‘A’ is to receive a bonus or salary. The employee subscribes for preferential shares of the employer. The preferential shares are purchased by a connected company of ‘A’, or are redeemable at a premium that reflects a portion of the employee’s annual salary or bonus, after a period of one year. In this manner, the employee receives the income as capital gain.

**Interpretation**

The acquisition of the preferential shares is part of an arrangement designed to avoid the tax that would have been required to be paid on salary. By this arrangement, there is a tax benefit and there is a misuse of the tax provisions. The Revenue would invoke GAAR with regard to this arrangement.

### *Example -20:*

**Facts:**

‘A’ company had a disputed claim with ‘Z’ company. ‘A’ transferred its actionable claims against ‘Z’ for an amount which was low, say, for example 10 % of the value of the actionable claim against ‘Z’ to a connected concern ‘B’ by way of a transfer instrument. ‘B’ transferred such claim to ‘C’ company and ‘C’ further gifted it to ‘D’ company, another connected concern of ‘A’. Upon redemption of such actionable claims, ‘D’ showed it as a capital receipt and claimed exemption.

**Interpretation:**

The transfer of actionable claims in the manner as detailed above to a connected concern is a colourable device which lacks commercial substance. The income in the instant case belongs to A. Revenue would invoke GAAR as regards this arrangement.

### *Example -21:*

**Facts:**

`A` company borrowed money from a company `B` and used that to buy shares in three 100% subsidiary companies of `A`. Though the fair market value of the shares was Rs. Y, `A` paid Rs. 6Y for each share. The amount received by the said subsidiary companies was transferred back to another company connected to `B`. The said shares were sold by ‘A’ for Rs. Y/5 each and a short-term capital loss was claimed and this was set-off against other long-term capital gains.

**Interpretation:**

By the above arrangement, the tax payer has obtained a tax benefit and created rights or obligations which are not ordinarily created between persons dealing at arm’s length. Revenue would invoke GAAR with regard to this arrangement.