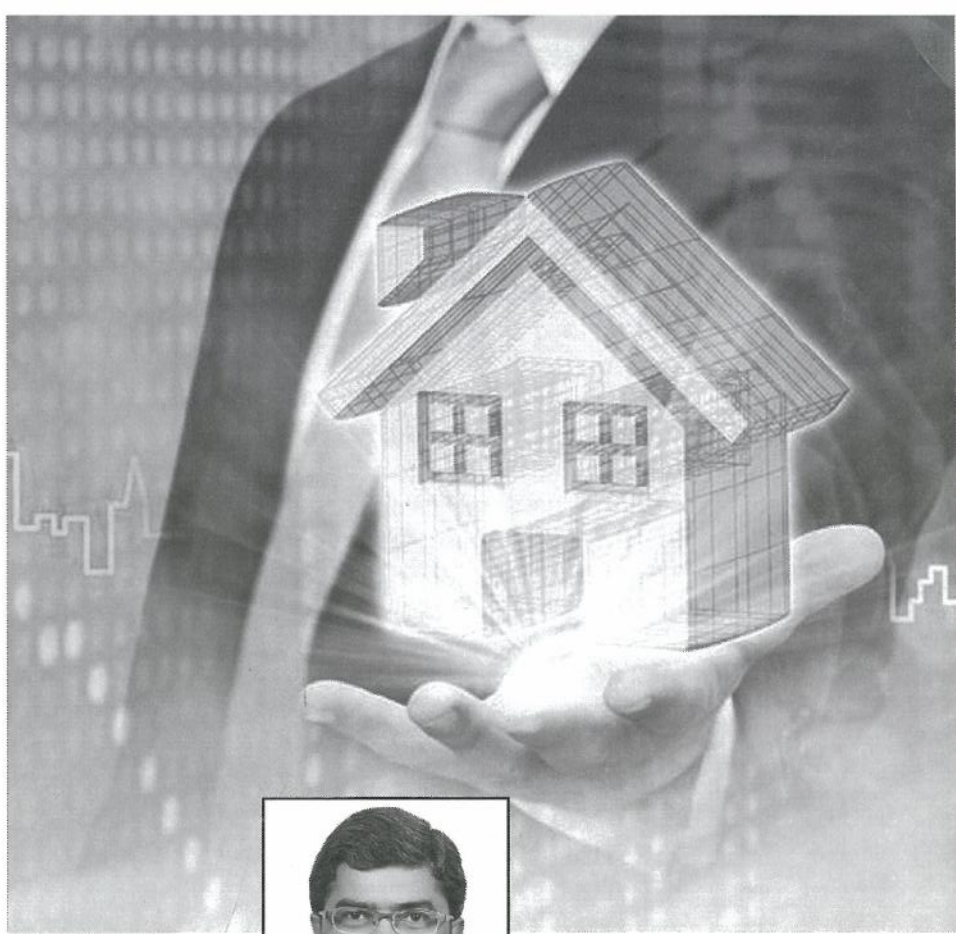

The Future of Tax Planning in the Era of GAAR

Nilesh Patel – CPA (USA), IRS (Former)

1. THE BEGINNING

These are uncertain times; these are exciting times. We are stepping out of the Old; we are stepping into the New. The path of taxation, a path on which we walk with undying enthusiasm, is bending ahead. Beyond the bend lies the new world of taxation, a world inhabited by BEPS, MLI, PoEM and GAAR. Of these, GAAR truly is intimidating, standing - sternly - in the way of tax planning, compelling us to instil an element of caution in all our tax planning ventures. Unless we equip ourselves to deal with the challenges posed by GAAR, unless we understand how GAAR affects tax planning, we will not succeed in serving those who, with such reverence, rely on us to take care of their tax matters. Our tradition of service urges us to ponder: how do we achieve tax-efficiency in the era of GAAR?

2. THE CASE OF A US COMPANY: INBOUND INVESTMENT INTO INDIA

To delve into the question set out above, let us take the case of a US Company (USCo) manufacturing medical devices. USCo wishes to sell its devices in India. For that purpose it is exploring various options: tax-efficient location for setting up an intermediate holding company; appropriate form (Branch, Subsidiary Company, LLP, Independent Agent, etc.) of entity - Indian Entity - selling devices in India; the right capital structure, that is, proper debt-equity-hybrid instrument mix, to finance the Indian Entity; ways to extract profits out of the Indian Entity in a tax-efficient manner when the Indian Entity begins to earn significant amount of profits.

3. ELEMENTARY ISSUES ARISING DUE TO GAAR

Imagine You are advising USCo on its foray into India. You need to ensure that the options chosen by USCo lead to tax-efficiency while also ensuring that GAAR does not result in high tax-cost.

To do so, You have to carefully consider the following issues:

i. How does GAAR affect the various options explored by USCo?

ii. With the advent of GAAR, can USCo structure the transactions mentioned above in a tax-efficient manner? How?

iii. Has GAAR killed tax planning?

iv. Will GAAR extract maximum possible tax from USCo, the Intermediate Holding Company and the Indian Entity?

v. What care should USCo, the Intermediate Holding Company and the Indian Entity take to mitigate the adverse implications of GAAR?

To resolve the issues highlighted above let us step into the enigmatic world of GAAR.

4. STATUTORY FRAMEWORK: AN OVERVIEW

The GAAR provisions are enshrined in Chapter X-A of the Income-tax Act 1961. The relevant sections of Chapter X-A are Sec. 95 to Sec. 102. Besides, Sec. 144BA of Chapter XIV too is relevant because it prescribes the procedure for assessment, including reference to "GAAR Approving Panel". There are also other provisions relevant to GAAR: overriding of tax treaties by GAAR, seeking advance ruling on applicability of GAAR, filing direct appeal before ITAT against the assessment order in GAAR cases, and non-filing of objections to Dispute Resolution Panel (DRP) in GAAR cases. In addition, we have four GAAR related rules in the Income Tax Rules 1962: Rule 10U, Rule 10UA, Rule 10UB and Rule 10UC. Then there is the CBDT Circular No. 7 of 2017 dated 27th January 2017 clarifying certain aspects of GAAR.

The relevant sections and rules are tabulated below.

4.1 Sections

Section	Description
Sec. 95	Applicability of General Anti-Avoidance Rule (GAAR)
Sec. 96	Impermissible Avoidance Arrangement
Sec. 97	When can we say that an Arrangement Lacks Commercial Substance?
Sec. 98	Consequences of Impermissible Avoidance Arrangement
Sec. 99	Treatment of Connected Person and Accommodating Party for determining tax benefit
Sec. 100	Application of GAAR in lieu of or in addition to other provisions of the Act
Sec. 101	Framing of Guidelines
Sec. 102	Definitions for purposes of GAAR
Sec. 144BA	Reference to Principal Commissioner or Commissioner and the GAAR Approving Panel

Section	Description
Sec. 90 (2A) and Sec. 90A (2A)	GAAR overrides Tax Treaties
Sec. 245N (a)(iv)	Application for Advance Ruling on applicability of GAAR
Sec.253 (1) (e)	Direct appeal before ITAT against the assessment order in GAAR cases
Sec. 144C (14A)	No Objections can be filed in GAAR cases to Dispute Resolution Panel (DRP)

4.2 Rules

Rules	Description
Rule 10U	GAAR not to apply in certain cases
Rule 10UA	Determination of consequences of impermissible avoidance arrangement
Rule 10UB	Notice and Forms for reference to the CIT and Approving Panel under Sec. 144BA
Rule 10UC	Time limits for various stages of assessment procedure in GAAR cases

4.3 Benevolent clarifications made by the CBDT through Circular

The Central Board of Direct Taxes (CBDT) has issued Circular No. 7 of 2017 dated 27th January 2017 providing important clarifications - in the form of 16 Questions and Answers - on implementation of GAAR provisions under the Income Tax Act 1961.

The Circular provides following benevolent clarifications:

a. If a case of avoidance is sufficiently addressed by Limitation of Benefit clause (LOB) in the treaty, the Tax Authorities shall not invoke GAAR.

b. GAAR will not interplay with the right of the Taxpayer to select or choose a method of implementing a transaction.

c. The Tax Authorities shall not invoke GAAR merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of Foreign Portfolio Investor (FPI) is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.

d. GAAR will not apply if an arrangement is ruled as permissible by the Authority for Advance Rulings (AAR).

e. GAAR will not apply to an arrangement where the Court or the National Company Law Tribunal has explicitly and adequately considered the tax implication while sanctioning an arrangement (such as merger, demerger, etc.).

f. GAAR shall not apply if the tax benefit obtained by all the parties to the arrangement is less than 3 crore per assessment year.

You may keep the above clarifications in sight while formulating a plan for tax efficiency.

5. BASIC CONCEPTS UNDERLYING GAAR

Chapter X-A of the Act includes GAAR provisions – these provisions have an overriding effect on other provisions of the Act. That is, GAAR applies to Taxpayer's transactions, notwithstanding any other provisions of the Act. Besides, by virtue of Sec. 100 GAAR can apply *in lieu of or in addition* to any other provision of the Act, such as Chapter X (Transfer Pricing), Sec. 94B (Limitation on deduction of Interest),

etc. GAAR applies to any arrangement that is considered an Impermissible Avoidance Arrangement (IAA). The overall scheme of GAAR provisions (Sec. 95 to Sec. 102) contained in Chapter X-A of the Act consists of two limbs: (i) determining the existence of an IAA resulting into tax benefit, and (ii) determining the tax consequences of the IAA – the consequences can include denial of tax benefit.

One may say that GAAR has two essential elements: IAA and Consequences of IAA.

It is notable that GAAR applies not only to cross-border arrangements but also to domestic arrangements. To prevent the Tax Authorities from applying GAAR, that is, to prevent Authorities from declaring an arrangement as an IAA, the Taxpayers have to establish the commercial reasons for arrangements carried out by them – the Taxpayers need to demonstrate that availing tax benefit was not the main purpose of their arrangements.

5.1 Impermissible Avoidance Arrangement (IAA)

- The statutory provisions [Sec. 96 (1)] categorise as IAA those arrangements where "the main purpose" is to obtain a tax benefit and, in addition, where one of the four tainting elements[1] listed in Sec. 96 (1) is also present.

- The term "arrangement" has a wide scope and includes a step or part of the arrangement[2].

- Where the main purpose of a step in, or part of, an arrangement is to obtain tax benefit GAAR will apply regardless of the fact that the main purpose of the whole arrangement is a non-tax commercial purpose[3].

If an arrangement entered into by the Taxpayer fulfils the conditions laid down in Sec. 96, then the Assessing Officer can declare that arrangement as an IAA, by following the procedure specified in Sec. 144BA[4]. The tax consequences of an IAA, including denial of tax benefit or a benefit under a tax treaty, shall be determined by the Assessing Officer in the manner laid down in Sec. 98.

5.2 Implications of GAAR: Consequences of IAA

Sec. 98 empowers the Tax Authorities to determine the tax consequences of an Impermissible Avoidance Arrangement (IAA). The consequences, in relation to tax, of an IAA, including denial of tax benefit or a benefit under a tax treaty, shall be determined in such manner as is deemed appropriate in the circumstances of the case, including by way of, but not limited to, the consequences specifically listed in Sec. 98. You can find below some of the consequences of an IAA as listed in Sec. 98:

- Disregarding, combining or re-characterising the steps or part or whole of an arrangement

- Disregarding any accommodating party or treating any accommodating party and any other party as one and the same person

- Deeming persons who are connected persons to be one and the same person

- Re-allocating any accrual, or receipt, of a capital nature or revenue nature, or any expenditure, deduction, relief or rebate

1. Four tainting elements listed in Sec. 96 (1) – The Arrangement (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 this Act; (c) lacks commercial substance or is deemed to lack commercial substance under section 97, 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.
2. Sec. 102 (1): Definition of "Arrangement"
3. See Sec. 96 (2)
4. Sec. 144BA provides for reference by the Assessing Officer to the GAAR Approving Panel

- Re-locating these: the place of residence of any party, the location of an asset, or the location of a transaction
- Denying treaty benefits
- Disregarding corporate structure
- Re-characterising equity-debt, capital receipt-revenue receipt, and any expenditure, deduction, relief or rebate

The Assessing Officer can apply any of the remedies mentioned above to deny the tax benefit obtained under an IAA.

A question comes up here: when GAAR is applied, can we request the Tax Authorities to make appropriate compensating adjustments to avoid double taxation? Please note that on determination of consequences in the hands of one of the participants of an IAA, a corresponding compensating adjustment in the hands of another participant, or the counterparty, will not be allowed, as clarified by the CBDT Circular No. 7 of 2017.[5]

6. THE CHOICE PRINCIPLE

You would know that the Choice Principle recognises the Taxpayer's right to choose that manner of implementing a transaction which minimises her or his tax liability[6]. If the Taxpayer is in a position to carry out a transaction in two alternative ways, one of which results in liability to tax and the other does not, he or she is at liberty to choose the latter. The Taxpayer is well within his or her right to choose any one event, out of two or more events, to minimize tax liability.

Tax legislation, in essence, offers a Taxpayer several choices. Even when a Taxpayer exercises his or her choice, motivated primarily by tax reasons, the Tax Authorities may find it difficult to insist that the Taxpayer's actions constitute tax-avoidance. However, if the Taxpayer applies the Choice Principle without discrimination, the effectiveness of GAAR will be significantly diluted. Therefore, this question inevitably surfaces: which choices are recognised, and which are curtailed by GAAR? It is necessary to consider whether, with the advent of GAAR, the Taxpayer still has a choice of structuring his or her transaction in a way which minimises taxes? Stated another way "whether the main purpose of the arrangement will be to obtain Tax Benefit if, out of available alternative transactions, the Taxpayer chooses to adopt a course which results in a lower tax liability?"

6.1 CBDT Circular No.7 of 2017 dated 27th January 2017

In this Circular the CBDT (Central Board of Direct Taxes) has provided certain clarification, in the form of Questions and Answers, on the application of GAAR. Question No. 3 and the related Answer which throws light on Taxpayer's right to choose a method for implementing a transaction are reproduced below:

Question No. 3: Will GAAR interplay with the right of the Taxpayer to select or choose method of implementing a transaction?

Answer: GAAR will not interplay with the right of the Taxpayer to select or choose method of implementing a transaction.

6.2 GAAR significantly dilutes Taxpayer's choice to structure transactions

In light of the clarification given in the CBDT Circular the Taxpayer is free to choose one of several direct methods (for example, lease versus purchase, sale of shares versus sale of assets, operating a branch versus a subsidiary, forming a company versus a LLP, appointing an independent sales agent versus a dependent sales agent, establishing a low-risk distributor versus a high-risk distributor, etc.) of implementing a transaction.

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5. The denial of corresponding compensating adjustments is unjust and will lead to double taxation. The taxpayers may approach Court against double taxation imposed through CBDT Circular. A Circular is a piece of delegated legislation and is not binding on the Taxpayer.
6. See (i) *Vodafone International Holdings BV vs. Union of India [2012] 17 taxmann.com 202 (SC)/[2012] 341 ITR 1 (SC); (ii) CIT vs. Shiv Raj Gupta [2014] 52 taxmann.com 425 (Delhi); (iii) CIT vs. Sri Abhayananda Rath Family [2002] 255 ITR 436 (Orissa); (iv) Bhoruka Engineering Industries Ltd vs. DCIT [2013] 36 taxmann.com 82 (Karnataka); and (v) CIT vs. Walfort Share and Stock Brokers Pvt. Ltd. [2010] 326 ITR 1 (SC)*

But, because of the statutory provisions of "Explanation to Sec. 95[7], Sec. 96 (2)[8], and the definition of Arrangement in Sec. 102 (1)[9]" the following types of choices made by a Taxpayer will not be immune from GAAR under the Choice Principle –

- Inserting unnecessary tax-motivated steps, in a commercially-driven arrangement, merely to obtain tax benefit.

- Achieving a business objective in a round-about or indirect manner to avoid tax, instead of a simple and direct manner.

To give an example, an Indian Company (IndCo) wishes to sell an asset to a third party acquirer. If IndCo sells the asset directly, liability to tax on capital gain will fasten on IndCo. A wholly-owned Indian subsidiary of IndCo has brought forward capital loss. To claim benefit of set-off of the subsidiary's loss against the capital gain, IndCo first transfers the asset to the subsidiary – such transfer is exempt under Sec. 47 (iv). After the transfer the subsidiary sells the asset to the third party acquirer, and sets-off the capital gain against brought forward capital loss. This indirect and round-about manner of selling the asset will be caught by GAAR though the overall purpose is disposing of the asset. By virtue of Explanation to Sec. 95 and Sec. 96 (2), GAAR curtails the choice of Taxpayer to minimise tax by inserting unnecessary tax-motivated steps and achieving a business objective in a round-about or indirect manner.

7. SERIES OF TRANSACTIONS – PREORDAINED TRANSACTIONS

The Explanation to Sec. 95 provides that GAAR may be applied to any step in, or a part of, the arrangement as it is applicable to the whole arrangement. This Explanation, we may say, codifies the Step Transaction Doctrine. The reason why this Explanation is enacted is that Tax Avoidance often arises due to tax-driven steps which are not otherwise illegal or forbidden.

Please also note Sec. 96 (2), a provision which empowers the Tax Authorities to take the stand that, when the main purpose of *a step or part* of an arrangement is to obtain tax benefit (in the above-mentioned example of IndCo such step or part is transfer of asset to the subsidiary) the main purpose of the whole arrangement is also to obtain tax benefit, even when actually the main purpose of the whole arrangement is to accomplish a commercial purpose, not to obtain tax benefit. Sec. 96 (2) codifies the Step Transaction Doctrine plus Business Purpose Test. This UK version - commonly known as Concept of Preordained Transactions - combines step transactions doctrine and business purpose doctrine to enable the Tax Authorities to overlook the steps that serve no business purpose.

Sec. 96 (2) factors in the possibility that the main purpose of a step or part of the arrangement can be inconsistent with main purpose of whole arrangement. This sub-section tackles situations where a purely tax-motivated Step is inserted into the whole arrangement that otherwise has a non-tax business purpose as the main purpose. In such situations the focus shifts from the whole arrangement to the tax-motivated Step, and as a result the tax benefit, though arising from the Step, becomes the main purpose of whole arrangement even when the main purpose of the whole arrangement is a commercial purpose.

7.1 The UK Concept of Preordained Transactions

It may be useful here to touch upon the concept of Preordained Series of Transactions. You may note that the concept of Preordained Series of Transactions was acknowledged by the Supreme Court of India in the cases of *Azadi Bachao*[10] and *Vodafone*[11].

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7. Explanation to Sec. 95 provides that the provisions of GAAR may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

8. Sec 96 (2) enacts that an arrangement shall be presumed, unless it is proved to the contrary by the assessee, 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.

9. According to the definition in Sec. 102 (1) Arrangement means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding…

10. *Union of India vs. Azadi Bachao Andolan (2003) 263 ITR 706/ [2003] 132 Taxman 373 (SC)*

11. *Vodafone International Holdings BV vs. Union of India [2012] 341 ITR 1/204 Taxman 408/17 taxmann.com 202 (SC)*

This concept was articulated by the House of Lords in the seminal Ramsay[12] case and further developed by the House of Lords in the cases of *IRC vs. Burmah Oil Co Ltd.*[13], *Furniss vs. Dawson*[14] and *Craven vs. White*[15].

In the case of *Craven vs. White*[16] the House of Lords held that in certain circumstances the Court would be justified in linking the beginning with the end so as to make a single composite whole. And then the composite whole transaction, instead of individual steps, can be subjected to the anti-avoidance rule. In that way appropriate fiscal results can be applied to the single composite whole. As laid down by the House of Lords in *Craven vs. White* the circumstances, in which the beginning can be linked with the end to form a composite transaction, are mentioned below:

(i) the series of transactions was, at the time when the intermediate transaction was entered into, preordained in order to produce a given result;

(ii) the intermediate transaction had no other purpose than tax mitigation;

(iii) there was at the time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and

(iv) the preordained events did in fact take place.

In the above-mentioned circumstances various steps of an arrangement can be combined to form a composite whole arrangement which can then be examined under GAAR. Applying this concept to the case of IndCo, discussed in Para 5.2 above, the Tax Authorities can combine the step of transfer of asset to the subsidiary with the step of sale by the subsidiary to the third party, and by combining in this manner the Tax Authorities can view the transaction as direct sale of asset by IndCo instead of sale by the subsidiary.

7.2 The US Step Transaction Doctrine

Similar to the concept of Preordained Series of Transactions is the doctrine of Step Transaction prevalent in the US. Under that doctrine a particular step in a transaction is disregarded for tax purposes if the Taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid US taxes[17]. The step transaction doctrine applies to "meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms"[18].

As the US Supreme Court eloquently put, *"a given result at the end of a straight path is not made a different result because reached by following a devious path."*[19]

8. CHANGE HERALDED BY GAAR IN THE AREA OF TAX PLANNING

Let us now see how has GAAR changed tax planning? GAAR has reversed decades-old jurisprudence on tax planning and has affected long-existing investment and operating structures. In the Pre-GAAR era, Tax Avoidance which was technically legal (in the sense that it complied with the literal provisions of the Act) but was undertaken with the sheer objective of obtaining a tax benefit, without any supporting justification in terms of commercial, economic or business purpose, was permitted by the Courts; but in the GAAR era that kind of Tax Avoidance will no longer be permitted. To combat Tax Avoidance GAAR introduces Business Purpose Test, Purposive Interpretation of the provisions of the Act, Substance-over-Form Doctrine and Arm's Length Concept way beyond the Transfer Pricing Regulations. So, GAAR restricts the scope of tax planning.

12. *W T Ramsay Ltd vs. IRC [1981] STC 174*
13. *IRC vs. Burmah Oil Co Ltd [1982] STC 30*
14. *Furniss vs. Dawson [1984] STC 153*
15. *Craven vs. White [1988] STC 476 HL*
16. *Craven vs. White [1988] STC 476 HL*
17. *Del Commercial Props., Inc. vs. Comm'r, 251 F.3d 210, 213-14 (D.C. Cir. 2001) aff'g 78 T.C.M. (CCH) 1183 (1999)*
18. *Grove vs. Comm'r, 490 F.2d 241, 246 (2d Cir. 1973)*
19. *Minn. Tea Co. vs. Helvering, 302 U.S. 609, 613 (1938) – Also see Comm'r vs. Clark, 489 U.S. 726, 738 (1989)*

The legal principles applicable to tax planning have changed under GAAR, as highlighted below:

- GAAR rejects the approach taken by Courts in a number of old cases to the effect that Taxpayers are free to use their ingenuity to reduce their tax bills by any lawful means
- The choice of Taxpayers to minimize their tax burden has been curtailed
- The Taxpayer has choice to structure a commercial transaction in a manner which minimises tax only if the transaction has a commercial or business purpose as its main purpose and does not contain any Tainting Elements
- Main purpose must not be to obtain tax benefit – transactions should be driven by business purpose, not by tax purpose – tax benefit can, however, be an incidental benefit like icing on the cake
- Tainting Elements, listed in Sec. 96 (1)[20], cannot be part of Tax Planning
- GAAR heralds Purposive Interpretation of the Act
  - Use of a Statutory Provision by the Taxpayer must be as intended by Parliament
  - The Taxpayer cannot use a Statutory Provision just to obtain Tax Benefit – such use can be viewed as an abuse of law under Purposive Interpretation
  - The Taxpayer can no longer exploit loopholes, gaps or defects in tax laws to his or her own advantage – no circumvention of provisions of Act, no playing around with words of a provision and no violation of the spirit of legislation
  - The Taxpayer can use a fiscal incentive available to her or him in the Act by submitting to the conditions and economic consequences that the particular incentive in the Act entails
- The main purpose should be a non-tax purpose (business purpose or commercial purpose or family purpose or investment purpose)
  - Where there is no non-tax or business purpose other than obtaining a tax benefit, such a tax benefit cannot be availed by taking advantage of some provisions, or lack of provisions, in the Act or the Treaty
- Substance prevails over Form
  - While analyzing a transaction, Substance should be selected over the legal Form. Transactions have to be real and cannot be looked at in isolation. The fact that transactions are legal does not imply that they are acceptable with reference to the underlying meaning embedded in the statute
- The principle of Substance-over-Form coupled with Purposive Interpretation of the statutory provisions leads us to the approach expressed in the Arrowtown case[21]:

  whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.
- The planning scheme must have Commercial Substance – Economic Substance Doctrine
  - There should be a co-relation between the tax consequences

20. The Four Tainting Elements listed in Clauses (a) to (d) of Sec. 96 (1) are – The Arrangement (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 this Act; (c) lacks commercial substance or is deemed to lack commercial substance under section 97, 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.
21. *Collector of Stamp Revenue vs. Arrowtown Assets Ltd (2004) 6 ITLC 454*

and economic consequences of a planning scheme

- The planning arrangement must 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
- GAAR imposes an overriding statutory limit on the extent to which Taxpayers can go in trying to reduce their tax bill - that limit is reached when the arrangements put in place by the Taxpayer to achieve tax-avoidance do not contain substantial commercial purpose and instead contain any of the four Tainting Elements
- GAAR permits 'look through' approach – this approach overrides the 'look at' approach enunciated by the Supreme Court in the *Vodafone Case*[22], and allows Tax Authorities to pierce the Corporate Veil as well as dissect a composite arrangement (for example, a structure formed by a web of holding companies)
- Accommodating (or Tax-Indifferent) Parties, defined in Sec. 97 (3), cannot be employed; and Connected Persons cannot be misused'
- Step Transaction Doctrine – Sec. 96 (2): Part of an Arrangement
  - Unnecessary steps just to obtain tax benefit cannot be inserted
  - Roundabout manner of implementing a transaction cannot be adopted
- Under the GAAR regime an arrangement cannot employ these features –
  - No round tripping of funds
  - No elements that have effect of offsetting or cancelling each other
  - No disguise of the value, location, source, ownership or control of funds
  - No location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose

9. SCOPE OF TAX PLANNING UNDER THE GAAR REGIME: A QUICK GLIMPSE

9.1 Main Purpose

There should be a *bona fide* non-tax purpose for undertaking transactions; purely tax-driven transactions will be rendered impermissible under GAAR.

The arrangement should essentially be initiated for business or commercial purpose, not for Tax Avoidance purpose. Once the Taxpayer decides to enter into an arrangement for business or commercial purpose, then he or she can plan to structure or carry out the arrangement in a way that minimizes tax liability, obtaining tax benefit as incidental to the business arrangement. So, the Taxpayers' transactions should be compelled or encouraged by business realities, imbued with tax-independent considerations, and not shaped solely by tax-avoidance features.

9.2 Tainting Element 1: Arm's Length Rights or Obligations

The Taxpayer's planning arrangement or transaction must create rights or obligations ordinarily created between people dealing at arm's length. This means that the terms and conditions of the arrangement are negotiated at arm's length, are fair, commercially reasonable, and consistent with the existing market conditions.

The arrangement or transaction should be carried out by the Taxpayer in a simple and direct way, that is, the way in which persons at arm's length would normally carry out the transaction, without inserting unnecessary steps. Otherwise, the Tax Authorities can disregard the intermediate Steps inserted to achieve a tax advantage.

22. *Vodafone International Holdings BV vs. Union of India [2012] 17 taxmann.com 202 (SC)/[2012] 341 ITR 1 (SC)*

9.3 Tainting Element 2: Misuse or Abuse of the Provisions of the Act

By virtue of the second Tainting Element listed in Sec. 96 (1)(b) - *'misuse or abuse of the provisions of the Act'* - GAAR invites the Courts and Tax Authorities to embrace purposive interpretation to find the object, spirit or purpose of the provisions of the Act relied upon by the Taxpayer for obtaining the tax benefit.

Under the purposive interpretation of the provisions of the Act the use of a provision must be as intended by the Parliament. The Taxpayer cannot use a statutory provision just to obtain Tax Benefit – this can be viewed as an abuse of law under purposive interpretation. Besides, the Taxpayer can no longer exploit loopholes, gaps or defects in tax laws, or circumvent the provisions of Act to his or her own advantage. A fiscal incentive available in the Act can, however, be used by submitting to the conditions and economic consequences that the particular incentive entails. So, a Taxpayer can avail of tax benefit by using the statutory provisions as intended by the Parliament.

The principle of Substance-over-Form coupled with Purposive Interpretation of the statutory provisions leads to the widely hailed approach expressed in the *Arrowtown* case[23]:

> *whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.*

9.4 Tainting Element 3: Lack of Commercial Substance

The tax-planning arrangement must have commercial substance. The necessary elements of the test of commercial substance are -

- Substance over Form test: The true intention of the parties must be reflected in the agreement. That is, the risks and rewards resulting from the transaction must be those that can be really expected from such a transaction. The actual conduct of the parties must be in accordance with their rights and obligations under the Agreement.
- The Taxpayer should not remain insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary. The Taxpayer should assume and bear the necessary economic risk.
- There should be a proportionate relationship between the actual economic expenditure or loss incurred by a party and the value of tax benefit obtained by that party.
- The loss claimed for tax purposes should be commensurate to the measurable reduction in the Taxpayer's net worth.
- The income, gains, expenditure or losses falling within the Indian tax net must be proportionate to the economic activity taking place, or the value added in India, especially where the transactions or arrangements are between associates within the same economic entity or business group.

9.4.1 *Features indicating commercial substance*

In order to possess commercial substance, the Taxpayer's arrangement must have the following features:

- There must be a realistic possibility of profit from the arrangement.
- The Taxpayer should have non-tax reasons (business, commercial, family, investment, etc.), for carrying out the transaction.
- The economic consequences of the transaction should be adequately researched – the research should be diligently documented.
- The Taxpayer must genuinely invest capital (at risk) in the transaction.
- The arrangement should result in consequences that are commensurate with the change in the Taxpayer's (or group of related Taxpayers') economic position.

23. *Collector of Stamp Revenue vs. Arrowtown Assets Ltd (2004) 6 ITLC 454*

- The arrangement should result in significant pre-tax profit, and should not rely wholly or substantially on anticipated tax reduction for significant post-tax profit.
- The value of the pre-tax economic benefits stemming from the transaction must be both: (i) substantial in comparison to the tax benefits; and (ii) higher than the return from an entirely risk-free financial investment.

9.5 Element 4: Means or Manner not ordinarily employed for bona fide Purposes

To keep this Tainting Element at bay the Taxpayer's arrangement should –

i. adhere to normal business practices

ii. be entered into in a manner that is consistent with how the Taxpayer has generally concluded the previous arrangements

iii. be in accordance with commercial practices in the Taxpayer's industry

iv. be usual or ordinary in the Taxpayer's industry

v. be simple and direct having no unnecessary steps

10. IMPACT OF OECD'S RECOMMENDATIONS TO PREVENT BASE EROSION AND PROFIT SHIFTING (BEPS)

Under its BEPS project the OECD has issued a number of recommendations for tackling Erosion of Tax Base and Shifting of Profit to Low-Tax (or No-Tax) Jurisdictions. India is committed to implement most of the recommendations. Going forward, not only GAAR but the BEPS recommendations also will cast a shadow on planning in the area of International Taxation. To avoid abuse of a Tax Treaty, due to Treaty Shopping and due to avoidance of Permanent Establishment (PE), and to curtail Tax Avoidance through other means, the Tax Treaties are being amended by signing of a Multi-Lateral Instrument (MLI). India has already signed the MLI in June 2017 notifying 93 (almost all) of its Tax Treaties for modification.

So, very soon we will see the amended Tax Treaties having, among other things, effective Limitation of Benefits (LoB) clauses and Principal Purpose Test (PPT) clauses, for preventing Treaty abuse in the form of Treaty Shopping. The amended Tax Treaties will also tighten Article 5 (Permanent Establishment) to counter the avoidance of PE. These changes will have an adverse tax impact on both inbound as well as outbound investments – the Intermediate Holding Companies will now have to demonstrate significant commercial justification as well as economic substance.

And because of measures to check the avoidance of PE, MNCs selling their products in India, or entering into Engineering, Procurement and Construction (EPC) contracts with Indian Companies, have to be extra-cautious in structuring their deals. Documentation of activities performed in India is now of prime importance.

Further, to obtain benefit of favourable tax-regimes (say, on R & D activity abroad), in overseas locations, an Indian Company must have sufficient commercial substance in the concerned jurisdiction.

11. INBOUND INVESTMENT STRUCTURING: BACK TO THE CASE OF USCO

Here, I nudge You to kindly look back at USCo introduced to You in the beginning. Haven't we ignored USCo and its concerns for long? It is time now to bring those concerns into the spotlight.

11.1 Setting up an Intermediate Holding Company in a favourable jurisdiction

USCo can choose to set up an intermediate holding company in a tax-efficient jurisdiction, such as Netherlands. The setting up of an Intermediate Holding Company in a favourable jurisdiction will be examined under the Principal Purpose Test (PPT Rule), the anti-abuse rule incorporated in the Treaty through

Multilateral Instrument (MLI)[24]. The PPT Rule of Treaties is enough by itself to counter Tax Avoidance, arising due to obtaining of Treaty Benefit by abuse of Treaties. To counter such Tax Avoidance it is not necessary to override Treaties by applying GAAR. PPT Rule will do the needful.

That is because the PPT Rule is stricter than GAAR[25]. This means that the setting up of an Intermediate Holding Company in a favourable jurisdiction must successfully pass the PPT Rule for claiming Treaty Benefit. If it does, GAAR will not impact the Treaty Benefit adversely.

11.2 Choosing appropriate form of business in India

To sell medical devices in India USCo can establish any entity - Branch, Subsidiary Company, LLP, Joint Venture, Low-Risk or High-Risk Distributor, Independent Agent, etc. - suitable for its business in India. USCo can even choose to carry on business in India without establishing a Permanent Establishment. This choice will not be questioned under GAAR, as clarified by the CBDT in Circular No.7 of 2017 dated 27th January 2017. In that Circular in Answer to Question No. 3 the CBDT has clarified that GAAR will not interplay with the right of the Taxpayer to select or choose a method of implementing a transaction.

11.3 Selecting suitable mix of financing

Coming to the financing of the Indian Entity (IE) USCo must decide on the right proportion of debt, equity and hybrid instruments. But the thin capitalisation rule of Sec. 94B will restrict the amount of debt. Besides, GAAR too can impose restriction on thin capitalisation, way beyond Sec. 94B can. And if, because of thin capitalisation, the financing arrangement is found to be an Impermissible Avoidance Arrangement (under GAAR) then the debt can be re-characterised as equity. That will lead to re-characterisation of interest payment by the Indian business entity into dividend payment, thus, resulting in disallowance of interest as well as imposition of Dividend Distribution Tax (DDT).

To prevent application of GAAR the debt-equity ratio should accord with creditworthiness of the Indian Entity. The ratio must be as found in arm's length situations where third party lenders have lent funds.

11.4 Extracting profits from India to foreign jurisdiction

Imagine five years have flown by. The Indian Entity (IE) selling medical devices of USCo has successfully established business in India and has derived significant amount of accumulated profits. USCo is planning to extract those profits in a tax-efficient manner.

USCo (through the intermediate holding company) can license its marketing intangibles (brand-name, logo and trade-mark) to the Indian Entity permitting the Indian Entity to use these intangibles by paying royalty. Besides, USCo (through the intermediate holding company) can finance the Indian Entity by debt to the extent permissible by thin capitalisation restriction, and also provide certain management services to the Indian Entity. In this way USCo can put in place arrangements for extracting profits from India by way of payments of royalty, interest and fees for management services, etc. by the Indian Entity to the intermediate holding company.

These arrangements should be driven by business and commercial considerations. If tax-driven, these arrangements can be treated as Impermissible Avoidance Arrangements (under GAAR) and, consequently, any tax benefit can be denied. On application of GAAR the payments of royalty, interest and service fees by the Indian Entity can be re-characterised as dividend payments, thus, resulting not only in disallowance of the payments but also in imposition of Dividend Distribution Tax (DDT) on the Indian Entity, if the Indian Entity is a

24. The Multilateral Instrument (MLI) has been introduced to implement the treaty related measures recommended by the OECD for prevention of Base Erosion and Profit Shifting (BEPS). The MLI, modifying the Tax Treaties, will exist alongside the existing Tax Treaties, to bring the Treaties in line with the treaty related anti-erosion and anti- abuse measures set out in the BEPS Action Plans. India has signed the MLI in Paris on 7th June 2017.

25. PPT Rule employs 'One of the Principal Purposes' test but GAAR employs 'The Main Purpose' test

company. Of course, if the Indian Entity is a LLP then it will not be liable to DDT, but even the LLP will bear the brunt of disallowance of royalty, interest and service fees.

You may note that if the Indian Entity is a company then it has a choice to distribute profits by way of either dividend or buy-back or capital reduction. Such choice will not attract adverse implications under GAAR.

11.4.1 *Can USCo extract profits by way of indirect loan?*

Say, the Indian Entity is a company, that is, a wholly owned subsidiary (Indian Subsidiary) of the intermediate holding company set up in Netherlands (NCo). The Indian Subsidiary places 100 Crores as term deposit with an Indian Branch of a Foreign Bank (say, Rabobank or Deutsche Bank), and in turn the Foreign Bank back-to-back lends 100 Crores to NCo. *[See Example 5B given in Part 4 of the Final Report (2012) of the Shome Committee on GAAR.]*

This is an arrangement comprised of a series of two transactions: term-deposit with the bank and back-to-back loan by the bank. This arrangement has the main purpose of extracting funds, out of reserves in the Indian Subsidiary, to Netherlands without payment of due taxes (DDT). The tax benefit is saving of DDT on distribution of profit by the Indian Subsidiary. The arrangement disguises the source of funds by routing it through the bank. Also, the bank may be treated as an accommodating party. Hence the arrangement shall be deemed to lack commercial substance, by virtue of Sec. 97 (1). Consequently, the loan amount would be treated as dividend distribution by the Indian Subsidiary to NCo.

Can the Indian Subsidiary (the Taxpayer) argue that the main purpose of the arrangement is to transfer the idle funds lying in its reserves to NCo, and that it is the Taxpayer's choice to make such transfer in a manner that achieves tax efficiency? Say, the Indian Subsidiary supports its argument by relying upon the loan agreements, interest payment by NCo to the bank, interest payment by the bank to the Indian Subsidiary, and the TDS or withholding tax deducted on interest payments. This argument wilts under the heat of the counter-argument that, although the main purpose (subjective purpose or intention) of the Taxpayer is to transfer funds, *the main purpose (objective purpose) of the manner in which the funds were transferred (which forms the arrangement in question)* is avoidance of tax. So, the objective purpose of the arrangement is obtaining of Tax Benefit. The arrangement of placing funds in a term deposit with the bank and then the bank lending funds to NCo has no non-tax commercial purpose. Its only purpose is to avoid DDT.

Insertion of Tax-Motivated Step

By inserting the step of term-deposit with the bank and indirectly remitting funds to NCo in a round-about manner, the Indian Subsidiary has circumvented the provisions for payment of DDT on dividend or deemed dividend. Had the Indian Subsidiary distributed profits directly to NCo the Indian Subsidiary would have been liable to pay Dividend Distribution Tax (DDT). Further, had the Indian Subsidiary directly given loan to NCo, such loan would have been deemed dividend under Sec. 2 (22)(e) and the Indian Subsidiary would have been liable to pay DDT under the Proviso to Sec. 115-O (1), inserted by the Finance Act 2018. But the DDT, payable on either direct distribution or direct loan, is avoided by inserting the step of term-deposit with the bank.

As pointed out in Para 6.1 (The UK Concept of Preordained Transactions) above, the House of Lords developed the concept of Preordained Series of Transactions in the cases of *Ramsay*[26], *IRC vs. Burmah Oil Co Ltd*[27], *Furniss vs. Dawson*[28] and *Craven vs. White*[29]. The concept of Preordained Series of Transactions was taken note of by the Supreme Court of India in the cases of *Azadi Bachao*[30] and *Vodafone*[31]. As explained by the House of Lords in the case of *Craven vs. White*[32] in certain circumstances (those

26. *W T Ramsay Ltd vs. IRC [1981] STC 174*
27. *IRC vs. Burmah Oil Co Ltd [1982] STC 30*
28. *Furniss vs. Dawson [1984] STC 153*
29. *Craven vs. White [1988] STC 476 HL*
30. *Union of India vs. Azadi Bachao Andolan (2003) 263 ITR 706/ [2003] 132 Taxman 373 (SC)*
31. *Vodafone International Holdings BV vs. Union of India [2012] 341 ITR 1/204 Taxman 408/17 taxmann.com 202 (SC)*
32. Ibid

circumstances are mentioned in Para 6.1 above) the Authorities would be justified in linking the beginning of an arrangement with its end, so as to make a single composite whole, and in applying the fiscal results of the single composite whole.

Besides, as mentioned in Para 6.2 (The US Step Transaction Doctrine) above, under the US Step Transaction Doctrine a particular step in a transaction is disregarded for tax purposes if the Taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid US taxes[33].

Further, as discussed in Para 5.2 (GAAR significantly dilutes Taxpayer's choice to structure transactions) above, the statutory provisions of "Explanation to Sec. 95[34], Sec. 96 (2)[35], and the definition of Arrangement in Sec. 102 (1)[36]", prevent the Taxpayer from avoiding tax by inserting unnecessary tax-motivated steps, in a commercially-driven arrangement, merely to obtain tax benefit. The statutory provisions of 'Explanation to Sec. 95 and Sec. 96 (2)', one may say, codify the UK Concept of Preordained Transactions and the US Step Transaction Doctrine in the Income-tax Act, 1961.

In light of what is discussed above, one may strongly argue that the main purpose of the arrangement - comprised of term-deposit with the bank and back-to-back loan by the bank - is to obtain Tax Benefit by avoiding DDT. So, GAAR will apply in this situation to impose DDT.

11.5 Exiting from India

To exit from India, a MNC like USCo can choose either the sale of shares or the sale of assets or transfer of business. Under the option of transfer of business USCo can further choose slump sale or slump exchange[37] or itemized sale or demerger. These choices will not be affected by GAAR. Even under GAAR a Taxpayer can choose the most tax-efficient manner of implementing a transaction; Taxpayer does not need to adopt that mode or manner which maximises his or her taxes.

12. THE ENDING

We have now arrived near the finishing line. Having reviewed the statutory framework, the concepts underlying GAAR, the choice principle, and the change heralded by GAAR in the area of tax planning; and, in the light of all these, having also analysed the options explored by USCo, we may now proceed to a closure of the issues raised at the beginning:

i. How does GAAR affect the various options explored by USCo?

   GAAR codifies Business Purpose Test, Substance-over-Form Doctrine, Commercial Substance Doctrine, Step Transaction Doctrine, and Purposive Interpretation Approach.

   In the GAAR era, the options chosen by USCo must be driven by business necessity and must have commercial justification. Though USCo can minimize the impact of taxation by choosing tax-efficient structures and forms, such choice is curtailed by GAAR. USCo cannot choose indirect or round-about transactions that include purely tax-motivated steps. The transactions should be simple and direct without unnecessary complexity, and must possess commercial substance. Further, USCo cannot look for gaps or loopholes

33. *Del Commercial Props., Inc. vs. Comm'r, 251 F.3d 210, 213-14 (D.C. Cir. 2001) aff'g 78 T.C.M. (CCH) 1183 (1999).*
34. Explanation to Sec. 95 provides that the provisions of GAAR may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.
35. Sec 96 (2) enacts that an arrangement shall be presumed, unless it is proved to the contrary by the assessee, 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.
36. According to the definition in Sec. 102 (1) Arrangement means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding…
37. In *CIT vs. Bharat Bijlee Ltd [2014] 46 taxmann.com 257/ [2014] 365 ITR 258 (Bombay)* it was held that transfer of a business for shares is exchange and not a sale, and so beyond the purview of Sec. 50B (computing capital gains in case of slump sale)

in the legal provisions, and by doing so USCo cannot attempt to misuse or abuse the provisions of either the Act or the Treaty. Tax benefit cannot be the main purpose of any transaction or arrangement though it can be an incidental purpose like icing on the cake.

ii. With the advent of GAAR, can USCo structure its transactions in a tax-efficient manner? How?

Yes. Even under the GAAR regime USCo can exercise the choice to structure its transactions in tax-efficient manner. But USCo cannot choose to avoid tax by -

- Inserting unnecessary tax-motivated steps, in a commercially – driven arrangement, merely to obtain tax benefit.
- Achieving a business objective in a round-about or indirect manner to avoid tax, instead of a simple and direct manner.

The transactions should be undertaken by USCo mainly to accomplish business objectives, and tax benefit should only be an incidental objective. Also, the transactions should possess commercial substance; the substance of the arrangement as a whole should be consistent with the form of its individual steps; no tax-indifferent accommodating parties should be roped in; no round-tripping of funds should be employed; and the transactions must change the cash flows and business risks of USCo, NCo and IE.

To achieve tax-efficiency USCo may choose –

a) a favourable jurisdiction such as Netherlands

b) suitable form of entity for doing business in India

c) right mix of debt-equity-hybrid instruments

d) to extract profits in a tax-efficient manner

e) to exit from India without a heavy tax-burden

iii. Has GAAR killed tax planning?

No. Even in the era of GAAR Taxpayers can plan their transactions and arrangements in a tax-efficient manner. Such planning, however, should be business-driven, not tax-driven. Besides, tax planning should now be substance-based and should duly comply with the statutory provisions without exploiting loopholes in those provisions. One has to be diligent in documenting the business rationale and commercial justification for undertaking various transactions.

iv. Will GAAR extract maximum possible tax from USCo, the Intermediate Holding Company and the Indian Entity?

No. As discussed above, GAAR permits Taxpayers to minimize their taxes. But to do so, Taxpayers must meet the necessary requirements, and avoid the Tainting Elements, laid down by GAAR as discussed above.

v. What care should USCo, NCo (the Intermediate Holding Company) and IE (the Indian Entity) take to mitigate the adverse implications of GAAR?

The Taxpayers (USCo, NCo and IE) must give a hard look at the investment structure, its commercial and economic purpose, its risk taking ability and location advantage, to determine whether they have adequate documentation to establish its commercial legitimacy.

Under the GAAR regime, Taxpayers will have to demonstrate substance and commercial reasons for every transaction or arrangement. And that leads to an

increased emphasis on documentation of the business rationale for any transaction or arrangement. Therefore, documentation that spell out the non-tax commercial reasons for a transaction is crucial.

The management must satisfy itself that no tax saving is achieved by unacceptable means, that is, by employing any of the Four Tainting Elements[38] which act as triggers for GAAR.

Finally, to obtain tax certainty, Taxpayers may look at the option of seeking Advance Rulings.

We now close the cases of USCo, NCo and the Indian Entity, with the assurance that GAAR has not killed tax planning. With this closure our discussion comes to an end.

Let this be the end of abusive tax avoidance, and the beginning of responsible, business-driven, substance-based tax planning. With this uplifting thought in our minds, everlasting hope in our hearts, and unending energy in our steps let us march forward to shape the future that beckons us into the era of GAAR.

38. The Four Tainting Elements listed in Clauses (a) to (d) of Sec. 96 (1) are – The Arrangement (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 this Act; (c) lacks commercial substance or is deemed to lack commercial substance under section 97, 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.

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