

Removing the fences

Looking through GAAR

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Preface



Rahul Garg
Leader
Direct Tax



Kaushik Mukerjee
Leader
Direct Tax Centre of
Excellence

General Anti-avoidance Rule (GAAR) is a concept which generally empowers the Revenue Authorities in a country to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit. Denial of tax benefits by the Revenue Authorities in different countries, often by disregarding the form of the transaction, has been a matter of conflict between the Revenue Authorities and the taxpayers. Traditionally, the principles regarding what constitutes an impermissible tax avoiding mechanism have been laid down by the Courts in different countries, with a series of decisions of the English Courts starting from the Duke of Westminster's case. In India also, the ruling of the Supreme Court in McDowell's case was a watershed. This ruling itself has been interpreted by different courts including the Supreme Court in various subsequent decisions. In its recent ruling in the famous Vodafone case, the Supreme Court has stated that GAAR is not a new concept in India as the country already has a judicial anti-avoidance history.

With the increasing globalisation of economies and growth in cross border transactions, some countries have introduced legislation which has empowered the Revenue Authorities to question transactions and arrangements and disregard their form to deny tax benefit unless the taxpayer can establish the commercial legitimacy of the transaction. However, different countries have taken different approaches in this regard. Australia was in the forefront of introducing a GAAR as early as 1981. Mature economies like Canada, New Zealand, Germany, France and South Africa have also introduced a GAAR. Emerging economies have also started introducing GAAR with the phenomenal growth of their economies. However, some of the leading nations like USA and UK have taken a cautious approach.

It is common for taxpayers to arrange their affairs in a way that will give them tax benefits, which are through genuine and legitimate actions. Over the past few years it has been noticed that the Revenue Authorities have attempted to deny tax benefits, whether under the tax treaty or domestic law, by disregarding the form and looking through the transactions. However, genuine transactions consummated in a tax efficient manner need to be distinguished from sham transactions or colourable devices used for evading tax. The approach of Revenue Authorities has resulted in protracted litigation and uncertainty. The Revenue Authorities' attempts in this regard have not succeeded in most cases, especially in the Supreme Court, the most recent being in the Vodafone case.

In India, there are specific anti-avoidance provisions in the domestic tax laws as well as 'limitation of benefits' clauses in some tax treaties. Additionally, the Government proposes to introduce GAAR provisions through the Direct Taxes Code. The proposed GAAR provisions would override the provisions of the tax treaties signed by India. The Direct Taxes Code Bill, 2010 (the Code), after its introduction in Parliament, was referred to a Standing Committee of Parliament. The Standing Committee has obtained the views and recommendations of various stakeholders. Currently the Standing Committee is examining the Bill. The Code, which was planned to be effective from 1 April, 2012 is expected to be delayed. However, given the importance of the GAAR provisions from the Government's perspective and the developments by way of the judicial outcomes of some important matters over some time, one would not be surprised if GAAR provisions are introduced in the current laws.

The purpose of this White Paper is to provide an analysis of the proposed GAAR provisions contained in the Code and recommendations vis-à-vis the proposed introduction of the GAAR. Revenue collection is one of the most important rights of the Government and associated with it is the introduction of measures to restrict taxpayers from entering into arrangements resulting in tax avoidance. However, as observed by the Supreme Court in the Vodafone ruling, strategic tax planning is permissible and one has to take a holistic view considering the entire scenario. Further, India is a preferred investment destination for multinational corporations. It is extremely important for investors that the investment destination has certainty in its tax policy and legislation. The GAAR is a measure which requires substantial discussion amongst the stakeholders before its introduction. Experience shows that countries in which a GAAR has been introduced in legislation have taken considerable time in its stabilization. Based on experience, one can say that stakeholders need awareness on the subject so that one does not lose sight of the entire scenario resulting in unintended consequences. With this objective, this paper is structured into the following sections:

- An introduction
- Specific Anti-Avoidance Rules
- Broad scheme
- Analysis - Provisions in the Code
- GAAR and treaty override
- Recommendations

We commend this White Paper to the stakeholders for their kind consideration.

Message



Michael Bersten

Partner PwC Australia &
Co-Leader of Tax
Controversy and Dispute
Resolution (Asia Pacific)

Global GAAR Leader, Tax
Controversy and Dispute
Resolution Network

It is a critical watershed for the tax system of any country to introduce a GAAR for several reasons. The need for a GAAR is usually justified by a concern that the integrity of the tax system needs to be strengthened. This in turn usually reflects a judgment by the Government and Parliament that existing laws, judicial practice and tax administration are not considered adequate to address current challenges and the anticipated requirements of future generations.

Inevitably such a judgment is controversial because of the different interests and opinions to be balanced between the community as represented by the Government and the Revenue on the one hand and on the other, specific elements of the tax base, such as citizens and more particularly business, residents and non-residents.

Debates about the need for a GAAR usually focus on competing policy interests such as the need for integrity of the tax system as against the legitimate interests of taxpayers to organize their affairs in a normal commercial or family way and the community benefits of economic growth resulting from business investment.

Debates also need to centre on the precise form of the GAAR for a given nation so that it is targeted to address effectively only the mischief that it should and to do so fairly so as to strengthen the confidence of all stakeholders in the system.

These debates are very important and require informed and balanced contributions from all stakeholders.

This white paper is intended to be an important contribution to the debate and India's national interest. In my opinion the white paper amply fulfils its intention and I commend it to the Government and all stakeholders for close and careful consideration.

It might be said that the debate about whether a GAAR is needed has been overtaken by the trend towards the introduction of the GAAR in an increasing number of countries such as my home, Australia (1981), but also China (2008), Canada and New Zealand.

This white paper surveys the GAAR in some of those jurisdictions. Moreover some GAARs are undergoing further review (such as currently in Australia) and there is no trend towards repeal of the GAAR. In the rare case of Poland, the GAAR was found to be unconstitutional and now a fresh GAAR proposal is under examination to replace it.

Nonetheless, it is important to be clear why a GAAR is necessary. Not all countries have them, and not all GAARs are the same. There is no international norm for the GAAR or the need for one.

The need for a GAAR should shape its form and administration. Inevitably GAARs have significant and punitive consequences when applied. It must follow that GAARs should be enacted carefully so that they are designed to address real mischief only and go no further. To ensure the tax system does not fall into disrepute, GAARs must be administered transparently and with abundant due process commensurate with their often draconian consequences.

Let me close with some experiences from Australia after 30 years with the current GAAR, which replaced a GAAR considered then by the Government and Parliament of the day to be inadequate. The GAAR continues to be the most complex and controversial tax legislation for all stakeholders. Its operation properly requires close attention to, evidence of fact and circumstance, which is critical to ensure that it only applies where and how it should. The Commissioner of Taxation has publicly raised the possibility that it should be strengthened given the trend of recent court cases on top of an existing review to update the current GAAR. Taxpayers and advisers also find the GAAR to be uncertain when unapplied to particular cases due to, in part to evidentiary issues and the difficulty of predicting judicial views. There is a concern that sometimes the GAAR is applied in cases that it should not be.

One may distil some of the central challenges in the design of the GAAR – achieving consensus on what the GAAR should focus on and how the rules work fairly, quickly and efficiently to effectively apply in those cases in a way that is certain, subject to judicial review and administered based on evidence of all relevant facts.

Further everyone should be skeptical as to whether the design intent of the GAAR truly translates into the legislation and administration. Future generations live with the benefits and the burdens. For example, Tax administrators may become frustrated by judicial interpretations that depart from their own. Taxpayers may also be bewildered by expectations of the GAAR having a limited impact only to find it becomes a risk to be faced far more broadly. Upfront transparency and consensus about design intent will not anticipate and avoid all problems but without it there is no hope.

It would be foolish to suggest any country has found all the answers. This white paper however is a unique and essential resource to ensure that the GAAR debate in India will find the right way to the best outcomes in this notoriously difficult and sometimes treacherous area.

Contents





<i>1. An Introduction</i>	<i>8</i>
<i>2. Specific Anti-avoidance Rules</i>	<i>11</i>
<i>3. Broad Scheme</i>	<i>13</i>
<i>4. Analysis - Provisions in the Code</i>	<i>15</i>
<i>5. GAAR and treaty override</i>	<i>22</i>
<i>6. Recommendations</i>	<i>28</i>
<i>Annexure A - The Vodafone Ruling</i>	<i>32</i>
<i>Annexure B - International perspectives on GAAR</i>	<i>35</i>
<i>Annexure C - Text of GAAR Provisions under the Code</i>	<i>52</i>
<i>Abbreviations</i>	<i>58</i>
<i>Reference books, sites & cases</i>	<i>60</i>

1. An Introduction

1.1. Stated objectives

On 12 August, 2009, the Indian Government released the draft Direct Taxes Code Bill (DTC 2009) and discussion paper for public debate. Subsequently, a Revised Discussion Paper was released in June 2010. A formal Bill to enact a law known as the Direct Taxes Code, 2010 (the Code) tabled in the Parliament on 30 August, 2010, was an outcome of this process.

The Code is meant to replace the current Income-tax Act, 1961 (the Act). Currently, the Code is pending consideration before the Standing Committee of Finance and the report of the Committee is still awaited. The stated effective date of the Code is 1 April, 2012.

For the first time the introduction of a General Anti-avoidance Rule (GAAR) into the Income-tax law of India is proposed. The Discussion Paper to the DTC 2009 states as follows:

Need for general anti-avoidance rule (GAAR)

- 24.1** *Tax avoidance, like tax evasion, seriously undermines the achievements of the public finance objective of collecting revenues in an efficient, equitable and effective manner. Sectors that provide a greater opportunity for tax avoidance tend to cause distortions in the allocation of resources. Since the better-off sections are more endowed to resort to such practices, tax avoidance also leads to cross-subsidization of the rich. Therefore, there is a strong general presumption in the literature on tax policy that all tax avoidance, like tax evasion, is economically undesirable and inequitable. On considerations of economic efficiency and fiscal justice, a taxpayer should not be allowed to use legal constructions or transactions to violate horizontal equity.*
- 24.2** *In the past, the response to tax avoidance has been the introduction of legislative amendments to deal with specific instances of tax avoidance. Since the liberalization of the Indian economy, increasingly sophisticated forms of tax avoidance are being adopted by the taxpayers and their advisers. The problem has been further compounded by tax avoidance arrangements spanning across several tax jurisdictions. This has led to severe erosion of the tax base. Further, appellate authorities and courts have been placing a heavy onus on the Revenue when dealing with matters of tax avoidance even though the relevant facts are in the exclusive knowledge of the taxpayer and he chooses not to reveal them.*
- 24.3** *In view of the above, it is necessary and desirable to introduce a general anti-avoidance rule which will serve as a deterrent against such practices. This is also consistent with the international trend.*

Under the GAAR provisions of the Code (for detailed text refer to Annexure C), an arrangement (including a step in or a part) shall be considered to be an impermissible tax avoidance arrangement, if it is undertaken with the main purpose of obtaining a 'tax benefit' and it:

1. creates rights or obligations, which would not be created if the transaction was implemented at arm's length; or
2. results, directly or indirectly, in the misuse of the provisions of the Code; or
3. lacks commercial substance in whole or in part; or
4. is entered into or carried out by means, or manner which would not be normally adopted for bonafide purposes.

If an arrangement is regarded as an avoidance arrangement, such an arrangement could be disregarded, combined with any other step in the transaction or re-characterized, or the parties to the transaction could be disregarded as separate persons and treated as one person or any accrual or receipt of a capital or revenue nature or any expenditure, deduction, relief or rebate

could be reallocated amongst the parties. The GAAR provisions permit application of the principles of lifting the corporate veil, substance over form test, economic substance test, and thin capitalization rules (ie re-characterization of debt into equity or vice versa). Thus, under the Code, the Commissioner of Income-tax (CIT) is empowered to declare an arrangement as impermissible if it has been entered into with an objective of obtaining a 'tax benefit' and it lacks commercial substance or bonafide purpose. The terms such as tax benefit, lacks commercial substance, bona fide purpose, etc have been defined in a wide manner.

The Code also provides that GAAR provisions will override the provisions of any tax treaty India has entered into. Furthermore, it has been provided that the provisions of the GAAR may be applied as an alternative for or in addition to any other basis for determination of tax liability in accordance with the guidelines to be prescribed by the Government.

The Revised Discussion Paper stated as follows:

2. *Apprehensions have been expressed that the GAAR provision is sweeping in nature and may be invoked by the Assessing Officer in a routine manner. Apprehensions have also been raised that there is no distinction between tax mitigation and tax avoidance as any arrangement to obtain a tax benefit may be considered as an impermissible avoidance arrangement. It has been represented that to avoid arbitrary application of the provisions, further legislative and administrative safeguards be provided. Besides suitable threshold limits for invoking GAAR should be considered.*
3. *GAAR legislation exists in a number of countries. Jurisdictions which do not have GAAR legislation impose significant additional information and disclosure requirements on tax practitioners regarding advance intimation and registration of tax shelters with the tax administration. These can be investigated and potentially abusive arrangements can be declared impermissible. A statutory GAAR can act as an effective deterrent and compliance tool against tax avoidance in an environment of moderate tax rates.*
- 3.1 *The proposed GAAR provisions do not envisage that every arrangement for tax mitigation would be liable to be classified as an impermissible avoidance arrangement. It is only in a case where the arrangement, besides obtaining a tax benefit for the assessee, is also covered by one of the four conditions i.e. it is not at arm's length or it represents misuse or abuse of the provisions of the Code or it lacks commercial substance or it is entered or carried on in a manner not normally employed for bona-fide business purposes, the GAAR provisions would come into effect.*

The following safeguards are also proposed for invoking GAAR provisions:-

- (i) The Central Board of Direct Taxes will issue guidelines to provide for the circumstances under which GAAR may be invoked.
- (ii) GAAR provisions will be invoked only in respect of an arrangement where tax avoidance is beyond a specified threshold limit.
- (iii) The forum of Dispute Resolution Panel (DRP) would be available where GAAR provisions are invoked.

Countries like Australia, New Zealand, Canada, South Africa, Germany, France and others have introduced a GAAR into their tax codes. The United Kingdom (UK), however continues to adopt the 'judges to decide approach' as far as the GAAR is concerned. However, UK tax laws do contain specific anti avoidance provisions. Recently, the UK has withdrawn proposed legislation on Anti Treaty Avoidance due to adverse feedback received during the consultation process¹. In December 2010, a study group² was constituted to analyse the need for a legislative GAAR in UK. In its recently submitted Report³ it was pointed out that a broad spectrum GAAR would not be beneficial for the UK tax system as it would carry "a real risk of undermining the ability of business to carry out sensible and responsible tax planning". However, the Report says that introducing a narrowly focussed GAAR which does not apply to reasonable tax planning, and instead targets abusive arrangements, would be beneficial.

The Supreme Court of India in its ruling in the case of **Vodafone International Holdings BV**⁴ has unequivocally reiterated the age old principle that all tax planning cannot be said to be illegal / illegitimate or impermissible. Genuine strategic tax planning is permissible. The Apex Court observed, upon analysis of various rulings of English Courts and that of the Supreme Court, that "piercing of the corporate veil", and "substance over form" tests may be invoked only after the Revenue is able to establish on the basis of facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant eg., a structure used for circular trading or round tripping or to pay bribes. The judgement of the Supreme Court is summarised in **Annexure A**.

1 Technical Note on Tax Treaties Anti-avoidance dated 1 August, 2011, www.publications.parliament.uk

2 Source: www.hm-treasury.gov.uk/tax_avoidance_gaar.htm

3 Report of the UK GAAR Study Group by Graham Aaronson QC, 2011

4 SLP (C) No. 26529 of 2010, Judgement dated 20 January 2012

It also needs to be noted that in recent times the Government of India has been specifically focusing on tax avoidance and tax evasion. With a view to obtaining adequate information, the Government has entered into Tax Information Exchange Agreements (TIEAs) with several countries⁵ with which India has not signed tax treaties. These TIEAs will enable the Indian Government to obtain information from the Governments of other countries for implementation of Indian tax laws. Further, the scope of the Article dealing with Exchange of Information of the tax treaties signed by India is also widened in some cases e.g. the tax treaty with Australia.

1.2. Tax evasion v. Tax avoidance

It is important to highlight the distinction between Tax Evasion and Tax Avoidance. The Organisation for Economic Co-operation and Development (OECD) has defined **tax evasion** as “A term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored i.e. the tax payer pays less tax than he is legally obligated to pay by hiding income or information from tax authorities”⁶. In case of tax evasion deliberate steps are taken by the tax payer in order to reduce the tax liability by illegal or fraudulent means.⁷ **Tax avoidance**, on the other hand is defined by the OECD⁸ as “term used to describe an arrangement of a tax payer’s affairs that is intended to reduce his liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow”. The key distinction being that in tax avoidance the key facts or details are not hidden by the tax payer but are on record. In Australia, the Ralph Review of Business Taxation has characterized tax avoidance as misuse or abuse of the law that is often driven by structural loopholes in the law to achieve tax outcomes that were not intended by Parliament but also includes the manipulation of law and focus on form and legal effect rather than the substance⁹.

Another term which is sometimes used while analysing tax evasion and tax avoidance is **tax planning**. The OECD defines tax planning¹⁰ as “arrangement of a person’s business and /or private affairs in order to minimise tax liability”. It may be noted that, in practice in some cases, the dividing line between tax planning and tax avoidance, or between permissible tax avoidance and impermissible tax avoidance, may not be clear.

It may be noted that the GAAR is not an antidote for ‘tax evasion’, but for ‘tax avoidance’. The GAAR cannot deal with tax evasion since it cannot deal with what is not reported. The Government has recognised that the GAAR is meant for tackling tax avoidance.



5 Bahamas, Bermuda, Isle of Man, British Virgin Islands, Cayman Islands, Jersey, Gibraltar, Monaco etc.

6 OECD, Glossary of tax terms

7 Draft Comprehensive Guide to the General Anti-Avoidance Rule By South African Revenue Service

8 OECD, Glossary of tax terms

9 Ralph Review of Business Taxation – A Tax System Redefined, July 1999,

10 OECD, Glossary of tax terms

2. Specific Anti-avoidance Rules

A GAAR typically comprises a set of broad rules based on general principles to counter potential avoidance of the tax in general, in a form which cannot be predicted and provided for at the time when the law is introduced. If enacted, this will be a new concept in Indian law.

On the other hand, Indian law has always had specific anti avoidance rules (SAAR) as distinct from GAAR. SAAR is a set of rules which target specific 'known' arrangements of tax avoidance. They specifically lay down the conditions or situations where they may be invoked. These cater to arrangements that Parliament has envisaged as representing arrangements which may already have happened or which could potentially happen for tax avoidance. The salient distinguishing features of GAAR and SAAR are as follows:

SAAR

- SAAR are more specific and help reduce time and costs involved in tax litigation.
- SAAR provide certainty to any taxpayer while arranging his affairs or while formalizing any arrangement.
- SAAR generally do not grant any discretion to the tax authorities.
- SAAR being specific, have a very limited scope of application and this may provide tax payers with an opportunity to find loopholes and circumvent these provisions.

GAAR

- GAAR necessarily involves granting discretion to the tax authorities to invalidate arrangements as impermissible tax avoidance.
- GAAR has a broader application resulting in it being interpreted in a more extensive manner.
- GAAR can more effectively counter the taxpayers 'out of the box thinking' in devising new means of tax avoidance.

2.1. SAAR in existing Indian law

Under the existing Indian tax law also, there are a number of SAARs which have been added over the years to cater for specific situations. Some of these provisions are contained in Chapter X of the Act; others are spread across other Chapters. Some of the key provisions have been tabulated below:

Areas Covered	Section under the Act	Corresponding Section ¹¹ under the Code
Deeming certain payments by closely held companies by way of loans and advances to specified shareholders/other specified entities as dividends	2(22)(e)	314(81)(I)(e)
Provision targeting transfer of income without transfer of assts	60	8(1)(a)
Provision in respect of revocable transfer of assets	61	8(1)(b)
Provisions relating to clubbing of income which prevent shifting of income from one person to another for tax reasons.	64	9
Provisions targeting avoidance of income-tax by transactions resulting in transfer of income to non-residents.	93	119
Provisions targeting avoidance of tax by certain transactions in securities, such as dividend stripping	94	120 and 121
Provision authorizing the AO to determine actual cost to the assessee in case of transfer of assets with a view to claim higher depreciation at an enhanced cost	Explanation 3 to section 43(1)	44(2)
Provisions meant to curb tax avoidance in case of sale and lease back transactions.	Explanation 4A to section 43(1)	44(5)
Provision to curb tax avoidance by transferring property at nil or inadequate consideration.	56(2)(vii), 56(2)(viia)	58(2)(h), 58(2)(i), 58(2)(j)
Disallowance of excessive or unreasonable payments to an associated person	40A(2)	115(1)

¹¹ For ease of reference the Clauses in the Code have been referred to as Sections in this Paper

2.2. Instances of application of SAAR in India

Some instances where judiciary in India has effectively applied the existing Indian SAAR provisions or SAAR provisions were inserted to counter tax avoidance are enumerated below:

- In the case of **P.K. Abubucker**¹², the assessee was the managing director of a company in which he had a substantial interest. The assessee's personal property was used as a godown by the company. In 1981, the premises were destroyed in a fire and the assessee reconstructed the premises. For the reconstruction, he was paid Indian rupees (Rs.)10,00,000/- in advance which was to be adjusted against the rent which the company would have to pay the assessee for using the premises in the future. The Assessing Officer (AO) assessed this advance as a 'deemed dividend' u/s. 2(22)(e) of the Act. The Kerala High Court upheld the AO's decision on the ground that even if the advance received was to be adjusted against future rent it was a deemed dividend. Further, the Supreme Court in the case of Miss P. Sarada held that "The loan or advance taken from the company may have been ultimately repaid or adjusted, but that will not alter the fact that the assessee, in the eye of law, had received dividend from the company during the relevant accounting period."
- In the case of **Om Sindhoori Capital Investment Ltd**¹³, the assessee company (second owner) purchased a furnace from another company (first owner) and leased it back to the same company, at a higher value. It then claimed depreciation on that higher value. The Tax officer observed that the furnace built several years ago and used ever since could not appreciate in value. He felt it was a sham transaction. The Tribunal held that Explanation 4A of section 43(1) of the Act was attracted and therefore, the cost to the appellant (second owner) would have to be limited to the written value as in the hands of the first owner before its transfer to the assessee.
- In the case of **VVF Ltd**¹⁴ the assessee, a company incorporated in India, gave certain interest free loans to its foreign subsidiaries. It contended that since it had sufficient interest free funds, it did not charge any interest on the loans so advanced. Applying the Transfer Pricing (TP) provisions, the Tribunal concluded that funding assistance by a parent company to its overseas subsidiaries without an arm's length interest would not satisfy the arm's length test, irrespective of commercial expediency. The Tribunal's verdict was in line with the Delhi Tribunal's ruling in the case of **Perot Systems TSI (India) Ltd.**¹⁵ In this case, it was observed that it is irrelevant whether or not the loans were provided from interest-free funds and whether the loans were commercially expedient or not. Given that the transaction involves lending of money by the assessee to its foreign subsidiaries; the transaction should be benchmarked by considering comparable transactions of foreign currency lending by unrelated parties.
- In the case of **Walfort Share & Stock Brokers**¹⁶ in respect of Assessment Year (AY) 2000-01, the assessee bought units of a mutual fund on 24.3.2000 (the record date) for Rs. 17.23 each and immediately became entitled to receive a dividend of Rs. 4 per unit. After the dividend payout, the net asset value of the unit fell by Rs. 4 to Rs. 13.23. The assessee redeemed the units on 27.3.2000 at Rs. 13.23 per unit and claimed a loss of Rs. 4. The dividend of Rs. 4 was claimed to be exempt under section 10(33) of the Act. The tax officer and the first appellate authority rejected the claim of loss on the ground that the transaction was entered into in a pre meditated manner and the loss was "artificial".

The Apex Court held in cases arising before 1 April, 2002 losses pertaining to exempt income cannot be disallowed. It further held that section 94(7) of the Act was inserted to curb tax avoidance by certain types of transactions in securities. By applying section 94(7) (inserted w.e.f. 1 April, 2002) in a case for the AYs falling after 1 April, 2002, the loss to be ignored would be only to the extent of the dividend received and not the entire loss. Losses over and above the dividend received would still be allowed. If the argument of the Revenue is accepted it would imply that before 1 April, 2002 the entire loss would be disallowed as not genuine but, after 1 April, 2002, a part of it would be allowable under section 94(7) of the act which can never be the intent of section 94(7). The Apex Court also observed that the assessee in this case made use of provisions of section 10(33) of the Act and that cannot be termed as 'abuse of law'.

¹² CIT v. P.K. Abubucker [2002] 259 ITR 507 (Kerala)

¹³ Om Sindhoori Capital Investment Ltd. v. JCIT [2002] 82 ITD 514 (Chennai)

¹⁴ VVF Ltd. v. DCIT [2010-TIOL-55-ITAT-MUM]

¹⁵ Perot Systems TSI (India) Ltd. v. DCIT [2010] 37 SOT 358 (Del); 130 TTJ 685; [2010-TIOL-51-ITAT-DEL]

¹⁶ CIT v. Walfort Share & Stock Brokers [2010] 326 ITR 1 (SC)

3. Broad Scheme

In this Chapter, the broad scheme of the GAAR is summarized. Chapter 4 then contains a brief discussion of each of the major specific provisions and the implications thereof.

3.1. Broad provisions

The GAAR is a broad set of provisions which grants powers to authorities to 'invalidate any arrangement', for tax purposes, if it is entered into by the assessee with the main purpose of obtaining a 'tax benefit'.

A tax benefit would include a benefit relating to Income-tax, Wealth Tax, Dividend Distribution Tax and Branch Profit Tax (which is sought to be introduced under the Code).

Apart from the 'tax benefit' test, the arrangement also has to satisfy at least one out of four additional tests discussed in the ensuing paragraphs.

The principal condition for invalidating an arrangement under the GAAR provisions is that the arrangement (or any step thereof) must have been entered into with the main purpose of obtaining 'tax benefit'. This condition in most cases, is likely to get satisfied automatically at the assessment stage itself. Given that, under the proposed law, specific presumption is to that effect, GAAR provisions will be attracted automatically unless the taxpayer is able to prove otherwise. This would cast an onerous burden on the taxpayer in such cases which will have to be discharged with appropriate positive evidence.

Once the test of the main purpose of tax benefit is satisfied, the taxpayer is required to undergo further scrutiny to pass various other critical tests to avoid the application of the GAAR provisions and prevent the possible action of invalidating the arrangement. These critical tests, include whether (a) the arrangement is not carried out in a manner normally not employed for bonafide purposes or (b) it is not at arm's length or (c) it results in direct or indirect misuse/abuse of the provisions of the Code or (d) it lacks commercial substance. Further, in accordance with the enlarged definition of the test of 'lack of commercial substance', it would also be necessary for the taxpayer to pass certain further tests such as: whether there is a significant effect upon the business risks or net cash flow of the concerned parties, the test of substance over form, whether the arrangement involves 'round trip financing' or any accommodating or tax indifferent party or any element having effect of offsetting each other and so on. Most of these tests (for details refer to Chapter 4) are highly subjective. If any one of these tests is satisfied, then the CIT would assume the jurisdiction to apply the GAAR provisions.

Such an arrangement would be regarded as 'Impermissible Avoidance Arrangement', and the CIT would have the power to invalidate the arrangement and determine the consequences thereof under the Code with exceptionally wide powers.

3.2. Applicability

It may be noted that the GAAR provisions would be applicable to all taxpayers irrespective of their residential or legal status (i.e. resident or non-resident, corporate entity or non-corporate entity). The provisions also apply to all transactions and arrangements irrespective of their nature (i.e. business or non-business) if, the tax benefit accrues to the taxpayer and he fails to establish that the main purpose of entering into that transaction/ arrangement was not to obtain tax benefit. For GAAR provisions, it is also not relevant whether transactions/ arrangements are entered into with group concerns or third parties and whether they are domestic or cross-border transactions. Threshold limits and guidelines for circumstances where the GAAR provisions can be invoked are expected to be provided under the Rules. However, the canvas of the GAAR provisions, if enacted in the present form, is exceptionally wide and the consequences are severe. The discretionary powers of the CIT are very subjective and also very wide. Of course, one may expect that while finally enacting the law, these apprehensions will be properly addressed and the provisions will provide effective safeguards against the possibility of unintended undue hardships to taxpayers and the possibility of abuse of the discretionary powers at the implementation level.

3.3. Scope and practical effect

The scope of the Indian GAAR is very wide as it seeks to cover within its ambit nearly all the arrangements (the term 'arrangement' is very widely defined to cover almost every transaction scheme, understanding etc.) which have an element of 'tax benefit' accruing to the taxpayer and for its wide coverage, necessary back-up provisions have also been made. Therefore, prima-facie, various business (even non-business) arrangements resulting in tax benefit may come-up for questioning under the GAAR provisions and considering past experience these may result in long drawn tax litigation. This may create a great amount of uncertainty in terms of tax and other implications of any such arrangement. Therefore, serious consideration needs to be given to these provisions by persons operating at all levels in an organisation including at the level of policy and decision making. In fact, while taking all commercial decisions and determining the manner of their implementation, the tax implications of these provisions may play a vital role.

3.4. Procedure

The task of invoking and administering GAAR provisions is entrusted to the CIT. It needs to be recognized that in the Indian tax administration scenario, the CIT is the head of the tax administrative jurisdiction, which consists of several AOs working under him. He is also largely responsible for achieving the targets of tax collections given to him by the Government. The possibility of conflict of interest in implementation of GAAR provisions in a fair and just manner, though unintended, cannot be ruled out.

The CIT is required to issue notice to the taxpayer requiring him to produce evidence, particulars, etc. on which the taxpayer relies in support of his claim that the arrangement in question is not an 'Impermissible Avoidance Agreement'. For this purpose, it is mandatory for the CIT to give the opportunity of hearing to the assessee. During the proceedings before the CIT, it is expected that the principles of natural justice will be followed.

Thereafter, the CIT is required to pass an order (within 12 months) if it is held that the arrangement is impermissible as contemplated in the GAAR. Then, he is required to give appropriate direction to the AO in his order. Interestingly, no specific time limit is provided for issuing such a notice. It seems that the notice should be issued before the time barring date for completing the relevant assessment. Based on these directions, the AO is required to pass a draft order. The remedy available to the taxpayer is to file objections before the DRP – consisting of three CITs. The DRP, after following the appropriate procedure, is required to decide the matter within a period of nine months and give appropriate directions to the AO who, in turn, is required to pass the final assessment order based on these directions. The taxpayer can file an appeal before the Income Tax Appellate Tribunal (ITAT) against the order. Considering past experience, the DRP should be made independent and should operate on the lines of ITAT to provide a real and effective remedy to the taxpayer. This will instill confidence amongst the tax payers, domestically as well as globally. Such a mechanism will also help in keeping India as a competitive destination for attracting foreign investments.

Once the CIT passes an order under the GAAR provisions, he is also required to send a copy to the CIT having jurisdiction over the other party involved in the arrangement. The other CIT will then proceed against the other party under the GAAR provisions. The other CIT may again independently examine the same arrangement. In a given situation, the other CIT may come to a different conclusion in relation to that other party.

3.5. Consequences

Once the provisions of the GAAR are invoked in respect of any arrangement, the CIT has been given wide powers to counteract the consequent tax advantages and to determine the tax consequences either by ignoring the arrangement in question or in any other manner as the CIT may deem appropriate, for the prevention or diminution of the relevant tax benefit. The CIT may negate, disregard, set aside or re-characterise any arrangement or he may derecognize one or more parties to the arrangement etc. The provision virtually empowers the CIT to lift the corporate veil to reallocate income/expenses/ deductions/ relief, negate transactions and even treat several entities as one for tax purposes. In certain cases, the findings and decision of the CIT may have even non-tax consequences under other laws. Effectively, the CIT would have enormous discretionary powers (which, of course, is expected to be judicially exercised) for prevention or diminution of the relevant tax benefit and determine the consequences of the arrangement in question under the Code. For example, in a given case, the CIT may treat a loan as capital and deny the deduction of interest. Upon such treatment, corresponding consequences may follow under the Code. Similarly business profit can be recharacterised as royalty or fees for technical services and taxed in India in the hands of a non-resident even in the absence of a Permanent Establishment (PE). Unless judiciously exercised, these actions can create issues in the home country of a non-resident taxpayer especially regarding characterisation of a genuine income transaction, especially where India has entered into a tax treaty with the other country. The Code also provides for overriding of tax treaty provisions where the GAAR is applied under the Code.

4. Analysis

Provisions in the Code

The provisions on GAAR in the Code can be broadly classified into

1. substantive; and
2. procedural provisions.

4.1. Substantive provisions

The substantive provisions are contained in Sections 123 to 125 of the Code.

4.1.1. Implication of *impermissible avoidance arrangement*

Section 123 of the Code provides that

- a. Any *arrangement*
- b. entered into by a person
- c. may be declared as an *impermissible avoidance arrangement*; and
- d. upon such declaration, the consequences that may follow, vis-à-vis the arrangement, are –
 - i. Disregarding/combining/re-characterisation of the arrangement in its entirety or in part or of any step thereof – including treating the arrangement not to have been carried out
 - ii. Ignoring any party to the arrangement or combining parties as one
 - iii. Reallocating any income or expense/ deduction, relief or rebate among parties to the arrangement
 - iv. Re-characterising equity into debt or vice versa or any income or expense, relief or rebate

The above treatment can be done alternatively to, or additionally over any other basis for determining tax liability in accordance with the guidelines to be prescribed.

The Government will notify rules prescribing the conditions and manner of application of GAAR provisions.

The key definitions contained in Section 124 are:

4.1.2. '*Arrangement*' means any step in or a part or whole of any transaction/ operation/ scheme/ agreement/ understanding including a case of alienation of property, whether legally enforceable or not.

4.1.3. '*Impermissible avoidance arrangement*' is defined as an arrangement (in its entirety or in part or any step thereof)

- a. whose main purpose is to obtain a tax benefit and
 - a. it:
 - i. creates rights or obligations which are abnormal in arm's length circumstances; or
 - ii. directly or indirectly results in misuse or abuse of the provisions of the Code; or
 - iii. wholly or partly lacks commercial substance; or
 - iv. is carried out by means or manner which would not normally be employed for bona fide purposes.

4.1.4. '*Tax benefit*' means –

- a. reduction/ avoidance/ deferral of tax or other amount or increase in refund of tax or other amount
- b. under the Code or by application of a tax treaty.

The definition of '*bona fide purpose*' is negative and excludes any purpose which –

- i. creates rights or obligations that would not normally be created between persons dealing at arm's length, or
- ii. results, directly or indirectly, in the misuse or abuse of the provisions of the Code.

A step in or a part or whole of an arrangement will be deemed as '*lacks commercial substance*' if –

- a. it does not have a significant effect upon the business risks, or net cash flows, of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained except for the provisions of GAAR;
- b. the legal substance or effect of the entire arrangement is inconsistent with or differs significantly from the legal form of its individual steps; or
- c. it includes, or involves:
 - i. round trip financing; or
 - ii. an accommodating or tax indifferent party; or
 - iii. any element having the effect of offsetting or cancelling each other; or
 - iv. a transaction(s) which disguises the nature, location, source, ownership or control of the fund.

4.1.5. '*Round trip financing*' would include financing in which funds are transferred among parties resulting in tax benefit but for the provisions of GAAR or significantly reduce, offset or eliminate any business risk incurred by any party.

4.1.6. An '*accommodating party*' means a party to an arrangement who derives any amount in connection with the arrangement due to his direct or indirect participation, which amount

- a. would or would not be included in this income instead of that another party or
- b. would be a tax deductible expenditure or loss for him instead of being non deductible/allowable for another party or
- c. result in prepayment by another party.

Section 125 of the code provides that an arrangement shall be presumed to be entered into or carried out for the main purpose of obtaining a tax benefit unless the benefitting party proves otherwise. For this purpose, the arrangement would be presumed to be so even if a step in or part of and NOT the whole arrangement is carried out or entered into for such purpose.

4.2. Analysis of substantive provisions

As mentioned earlier, the stated objective of the GAAR is to prevent erosion of the Indian tax base from the use of sophisticated methods of tax avoidance allegedly adopted by tax payers after the liberalization of the Indian economy. The introduction of the GAAR is also sought to be justified on the argument that while dealing with such cases, the Appellate Authorities and Courts have been placing a heavy onus on the Revenue even though the relevant facts are in the exclusive knowledge of the tax payer and he chooses (allegedly) not to reveal them.

The GAAR provisions are, therefore, proposed to be introduced in the Code whereby any arrangement can be declared as an impermissible avoidance arrangement and invalidated if any part/ step or whole of the arrangement fails to pass the two following tests:

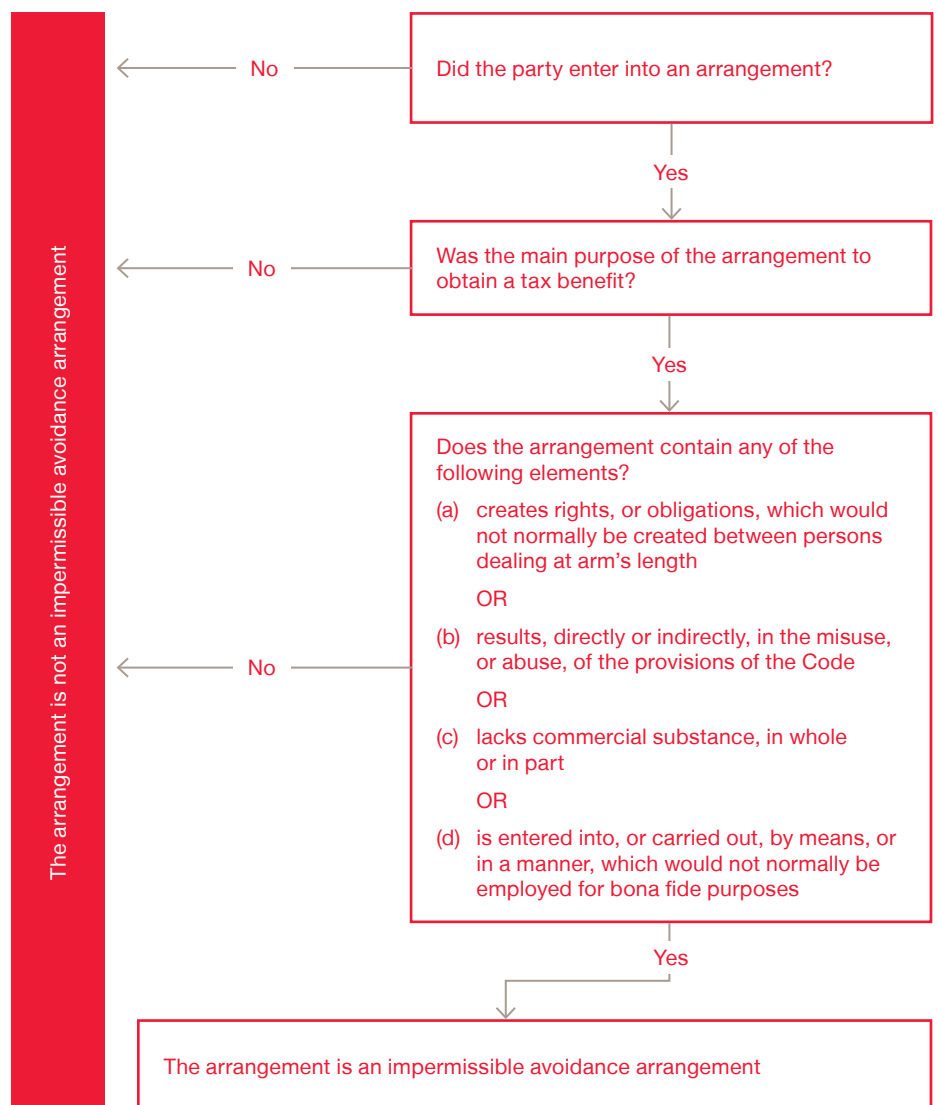
- a. Main test: The arrangement is entered into for the main purpose of deriving a tax benefit.
- b. Critical test: Any one of the tests below –
 - It creates *rights, or obligations*, which would *not normally* be created between persons dealing at *arm's length*

- It results, directly or indirectly, in the *misuse, or abuse*, of the provisions of the Code
- It *lacks commercial substance*, in whole or in part; or
- It is entered into, or carried out, by means, or in a manner, which would *not normally* be employed for *bona fide purposes*.

Diagrammatically, these provisions can be presented as follows:

4.3. Scope and the main test

The term 'arrangement' as defined in the Code covers any transaction, whether legally enforceable or not. Further, the main test measurable in monetary terms is the tax benefit. The expression 'main purpose' is subjective in nature. The definition of 'tax benefit' is also very wide and includes even deferral of tax to a later



year as well as tax treaty benefits. These provisions combined together could bring each and every transaction which results in a lower tax liability for the taxpayer than some alternative arrangement, as a subject matter for scrutiny under the GAAR.

For example, the write-off of a bad debt, as compared with making a provision for the bad debt, carries a lower tax liability for the taxpayer. This could be scrutinized using the GAAR provisions. Similarly, the GAAR could be incorrectly used to even deny investment based tax incentives which are otherwise granted under the Code.

Of course, the threshold of the four alternative critical tests mentioned above will also have to be met in order to treat an arrangement as an 'impermissible avoidance arrangement'. However, the onus of proving to the contrary that the main purpose of entering into the transaction was not to obtain tax benefit lies with the taxpayer. This would therefore leave the CIT with extremely wide powers to invoke the GAAR or at least initiate proceedings. Additionally, there is no monetary threshold restricting the invoking of GAAR. Given the experience of a spate of add backs/disallowances and consequent litigation after the ruling of the Supreme Court in McDowell's case¹⁷, one may expect a huge spurt in litigation after the introduction of the GAAR provisions. This would be against the stated objectives of introducing the Code.

Rationalisation of the scope of GAAR provisions is to be introduced through Rules to be notified by the Government. However, such an important safeguard should not be delegated to an executive authority. Parliament has powers to make laws to check avoidance of tax. However grant of unrestricted powers to the CIT under the Code and leaving the power to impose the restrictions on that power to executive authority could also be subject to challenge with regard to its constitutional validity. Rather, Parliament should legislate the restrictive conditions and thresholds in the Code itself.

Reference in this regard can be drawn to the GAAR provisions under the South African tax laws.

The application of South African GAAR provisions require fulfilment of four requirements, namely¹⁸:

- The existence of an arrangement
- The existence of a tax benefit (that is, an arrangement resulting in a tax benefit)
- The sole or main purpose of the avoidance arrangement is to obtain a tax benefit
- The avoidance arrangement is characterised by the presence of any one or more of the tainted elements for arrangements, which renders it an impermissible avoidance arrangement.

Once it is established that an arrangement is an avoidance arrangement, as defined, the next step is to determine whether that avoidance arrangement is an impermissible avoidance arrangement within the meaning of the South African GAAR. This will be the case if the sole or main purpose and the requirements of any one or more of the tainted element tests are met viz.,

- It was entered into or carried out by means or in a manner, which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit.
- It lacks commercial substance, in whole or in part
- It has created rights and obligations that would not normally be created between persons dealing at arm's length.
- It would result directly or indirectly in the misuse of the abuse of the provisions of the South Africa Income Tax Act (including the provisions of the GAAR).

It can be noted that the tainted elements under the South African GAAR are similar to the four critical tests in the proposed Indian GAAR. However, in South Africa a distinction is carved out between an avoidance arrangement and an impermissible avoidance arrangement.

While analyzing the term 'main purpose' under the proposed Indian GAAR, an issue arises as to how the main purpose is determined. Is it determined based on the intention of the parties or do the facts and

circumstances also need to be taken into account? Further, what is the point of time the main purpose is to be considered? Considering that the term main purpose is not defined in the proposed Indian GAAR, cue may be taken from GAAR provisions in other countries.

In the discussion paper¹⁹ on the South African GAAR, the term 'main' is explained as follows:

"The term 'main' has generally been construed to mean predominant..."
"... 'Main' refers to the set of significant purposes rather than to any individual purposes...."

Further, reference can be drawn from the South African case laws, the word 'mainly' has been construed as –

- A purely quantitative measure of more than 50%;²⁰
- As conveying the idea of dominant;²¹ or
- More than anything else, for the most²².

¹⁷ *McDowell & Co. Ltd. v C.T.O.* [1985] 154 ITR 148 (SC)

¹⁸ Section 80A of South Africa Income Tax Act

¹⁹ SARS Discussion paper on tax avoidance and section 103 of the Income Tax Act (Act No 58 of 1962), November 2005

²⁰ *SBI v Lourens Erasmus (Edms) Bpk* 1966 (4) SA 434 (A), 28 SATC 233

²¹ *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184

²² *Concise Oxford Dictionary (Tenth Edition)*

When determining the purpose of an arrangement, the time of implementation thereof is crucial and not the time of conceptualisation²³. In the case of *Ovenstone*, it was observed that -

“It appears from its provisions that the question whether or not the scheme in question is hit by them must be answered by reference to the effect and purpose of the scheme and the circumstances surrounding it at the time it is implemented or carried out, and not at the time it was formulated, ie conceived, decided or agreed upon, or otherwise evolved. For it is only when it is implemented or carried out that it becomes a practical reality concerning the fiscus; in particular, it is only then that its purpose and effect in respect of the taxpayer’s liability for income tax arise for consideration. True, s 103(1) repeatedly speaks of ‘any transaction, operation or scheme entered into or carried out’. But ‘entered into’ there does not mean ‘formulated’ in the abovementioned sense. Because of its context it has, I think, a connotation of implementation that is similar to ‘carried out’. Probably both expressions were used because it was considered that ‘carried out’ is more appropriate to connote the implementation of a ‘scheme’, while ‘entered into’ is more apposite to connote the implementation (ie the taxpayer’s actually engaging in) of a ‘transaction’ or ‘operation’. It follows therefore that, even if the purpose or effect of the scheme when it is formulated is not to avoid liability for tax, it may have that effect or that may become one of the taxpayer’s main purposes when he subsequently carries it out, thereby rendering s 103(1) applicable if its other requirements are fulfilled.”

The South African Revenue Services (SARS) Draft Guide to GAAR²⁴ further provides that when determining the ‘sole or main purpose’ of the avoidance arrangement, regard must be had to the relevant facts and circumstances of the arrangement and not to the subjective purpose or intention of a participating taxpayer, either at the time the arrangement is entered into or subsequently. The purpose of a party to the transaction may be taken into account as one of the relevant facts, but this will not be the determining factor in making such objective determination.

According to the Canadian GAAR, an ‘avoidance transaction’ is defined as a transaction, or one that is a part of a series of transactions where the single transaction or the series results directly or indirectly in a tax benefit, unless the transaction *may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.*²⁵

The Federal Court of Canada in the case of *OFSC Holdings*²⁶ observed that *“the words ‘may reasonably be considered to have been undertaken or arranged’ in subsection 245(3) indicate that the primary purpose test is an objective one. Therefore the focus will be on the relevant facts and circumstances and not on statements of intention. It is also apparent that the primary purpose is to be determined at the time the transactions in question were undertaken. It is not a hindsight assessment, taking into account facts and circumstances that took place after the transactions were undertaken.”*

However, the Information Circular²⁷ issued by the Canada Revenue Agency (CRA) providing guidance with respect to the application of the GAAR states that the purposes of a transaction are determined not only from the taxpayer’s statement of intention but also from all the circumstances of the transaction or transactions. If it can be inferred from all the circumstances that the primary or principal purpose in undertaking the transaction is other than to obtain a tax benefit, then the transaction is not an avoidance transaction.

4.4. Critical tests

4.4.1. Abnormal Rights and Obligations Test

This test deals with the creation of any right or obligation between parties to the arrangement which would not normally be created between persons dealing at arm’s length. This test is extremely uncertain as there is no common framework of what is ‘normal’ in the commercial world. The bulk of commercial transactions are between parties dealing at arm’s length. Despite this, even a person who has extensive experience of commercial transactions will find it difficult to find a common thread of what constitutes ‘normal’ in such transactions. Any person who evaluates what is ‘normal’ for the purposes of implementing the GAAR will have to put himself in the shoes of the businessman who is entering into the transaction. The fact that, in the real commercial world, under the same set of circumstances, two different businessmen may enter into transactions with significantly different rights and obligations cannot be ignored. Any person who does not have this framework of knowledge is likely to find a far larger number of rights and obligations to be abnormal.

4.4.2. Misuse or Abuse Test

This test deals with the ‘misuse’ or ‘abuse’ of the provisions of the Code. However, what constitutes ‘misuse’ or ‘abuse’ is very subjective in nature. In the absence of explicit statements of intent for each and every section of the Code this may not be a workable test.

The Supreme Court of Canada in the case of *Canada Trustco*²⁸, at para 43 of the ruling held that a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the Income Tax Act that are relied upon by the taxpayer is required in order to determine whether there was abusive tax avoidance.

23 *Ovenstone v CIR* 1980 (2) SA 721 (A), 42 SATC 55

24 Draft Comprehensive Guide to the General Anti-Avoidance Rule issued by the SARS

25 Section 245(3) of the Income Tax Act, Canada

26 *OFSC Holdings Ltd v. The Queen* 2001 FCA 260 para 46

27 IC 88-2 – General Anti-avoidance Rule: Section 245 of the Income Tax Act issued on 21 October, 1988

28 *The Queen v. Canada Trustco Mortgage Company* 2005 SCC 54

The Information Circular²⁹ issued by the CRA while interpreting the principle of ‘misuse or abuse’ states that transactions that rely on specific provisions, whether incentive provisions or otherwise, for their tax consequences, or on general rules of the Act can be negated if these consequences are so inconsistent with the general scheme of the Act that they cannot have been within the contemplation of Parliament. On the other hand, a transaction that is consistent with the object and spirit of provisions of the Act is not to be affected.

According to the SARS, a tax benefit may be denied under the South African GAAR, if that tax benefit would misuse or abuse the object, spirit or purpose of the provisions of the Income Tax Act that are relied upon for the tax benefit. This clearly requires a purposive approach to interpreting the provisions of the Income Tax Act. The introduction of the misuse or abuse test is specifically directed at ensuring that the remedy provided by the section is advanced and that the mischief against which the section is directed is suppressed. As a result a mere literal interpretation of the provisions will no longer safeguard a taxpayer who applies the provisions in the Income Tax Act in a context or manner which is not intended by the Income Tax Act.

Even the Canadian or South African framework does not assist in interpreting the test since this framework would also require a fair degree of precision with regard to what Parliament intended.

4.4.3. Commercial Substance Test

In the third test, an arrangement is deemed to be *lacking commercial substance* if it does not have a significant effect upon the business risks, or net cash flows, or the legal substance, or effect of the avoidance arrangement as a whole is inconsistent with or differs significantly from the legal form of its individual steps, or it includes round trip financing, etc. The terms ‘*accommodating party*’ and ‘*round trip financing*’ have also been defined in the Code in the widest amplitude.

The description of the test in the Code read with the definition of some selective terms makes the tests subjective and open to conflicting interpretation. Objective

language and guiding principles are required in the Code to make the tests meaningful and reduce the chances of litigation. The concept of ‘commercial substance’ should be judged from the point of view of the commercial reality of each case. Therefore it would not be correct to define such a commercial concept artificially.

4.4.4. Bona fide purpose test

An arrangement would become impermissible by application of this critical test if it is entered into or carried out, by means, or in a manner, which would not normally be employed for bona fide purposes

The definition of ‘*bona fide purpose*’, as stated before, is a negative one and excludes sub-clauses (a) and (b) of section 124(10) of the Code which are literally the abnormal rights and obligations test and the misuse or abuse test. This round tripping of the clauses does not serve any purpose. The definition needs to be deleted. ‘*Bona fide purpose*’ is a general concept. Normally, once all the facts are understood in a given situation, one instinctively knows what is bona fide and what is not. However, most people would be hard pressed to draw an objective dividing line between the two. Any definition which tries to draw such a line is certain to fail.

Overall, according to the definition of the terms ‘*impermissible avoidance arrangement*’, a transaction/ arrangement would be treated as an impermissible avoidance arrangement if it satisfies the main tax benefits test and any one of the critical tests. The alternative criteria vis-à-vis the critical tests for application of the GAAR, in the proposed form would create impediments to genuine business transactions in as much that the wide criteria would somehow get attracted even where tax avoidance is not the intention of the taxpayer. The GAAR provisions in the Code go against the age old principle laid down by various Courts and reiterated by the Supreme Court of India in its ruling in Vodafone’s case that a taxpayer is entitled to arrange his affairs in a tax beneficial manner. The definition of ‘*impermissible avoidance arrangement*’ should be narrowed down with objective, cumulative and lesser criteria.

4.5. Presumption and burden of proof

Under the GAAR provisions³⁰, the onus to prove that tax benefit was not the main purpose of the transaction/arrangement is on the taxpayer and the presumption would be so unless proved to the contrary by the taxpayer.

The taxpayer, thus, would be saddled with the responsibility to prove a negative.

The CIT on the other hand is given the power to treat an arrangement as an impermissible avoidance arrangement by using any one of the critical tests which are extremely wide and vague. This could lead to inappropriate use of the provision. To make the provisions fair to genuine taxpayers and to prevent inappropriate use, specific provision should be made that the initial burden of proof of the allegation that the sole purpose of the arrangement is to obtain a tax benefit should be on the Authority and the taxpayer’s responsibility would be to prove that the main purpose of the arrangement is commercial. Additionally, it should be made mandatory for the Authority to establish the application of the critical test with facts and evidence. For this, the necessary facts and evidence may be gathered from the taxpayer.

The Supreme Court of India in its ruling in Vodafone’s case, has held following the ‘look at principle laid down by the House of Lords in a series of rulings starting from the Duke of Westminster case³¹, that the Revenue Authorities must look at a document or a transaction in a context to which it properly belongs. It is the task of the Revenue / Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferent / saving device but that it should apply the ‘look at’ test to ascertain its true legal nature. In short, the onus will be on the Revenue Authorities to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device.

29 IC 88-2 – General Anti-avoidance Rule: Section 245 of the Income Tax Act issued on 21 October, 1988

30 Section 125 of the Code

31 The commissioners of Inland Revenue v. His Grace the Duke of Westminster 1935 All E. R. 259

In short, the ‘look at’ principle would apply to a normal commercial transaction. The ‘look through’ principle would apply when the Revenue Authorities can establish that the transaction is a sham and preordained colourable device. In other words, the GAAR, according to the settled jurisprudence can be applied only in the case of sham or artificially devised tax avoidance transactions. This principle should apply to the GAAR provisions under the Code.

Section 125(2) of the Code empowers the CIT to invoke GAAR provisions if any of the steps on a standalone basis are found to be undertaken to obtain a tax benefit, even though the main purpose of the entire transaction is not so. This provision would put a genuine business/transaction with a commercial purpose on the wrong side of the GAAR provisions. Therefore, once the arrangement as a whole is commercially justifiable then the question of invoking the GAAR should not arise. This approach would be in accordance with the Supreme Court’s ruling in Vodafone’s case which held that a transaction should be looked at holistically rather than being dissected to check tax avoidance.

In South Africa the onus is on SARS to establish the presence of at least one tainted element in order to apply the GAAR.

4.6. Re-characterisation

As a result of invoking the GAAR on an impermissible avoidance arrangement, any accrual, or receipt, of a capital or revenue nature or any expenditure, deduction, relief or rebate of an impermissible arrangement may be re-characterised.

An example of re-characterising may be found in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations³². This states that where the economic substance of a transaction differs from its form, it may be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction³³ and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an Associated Enterprise (AE) in the form of interest-bearing debt when, at arm’s length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for the tax authorities to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.

One may note that in Australia, on invocation of GAAR provisions, the tax authorities merely cancel the tax benefit.

4.7. GAAR versus Tax Treaty benefits

Please refer to Chapter 5.

4.8. Procedural provisions

Section 154 of the Code contains the procedure for invoking the GAAR.

The CIT is empowered and required to issue a notice³⁴ to the taxpayer asking him to produce evidence or particulars to support his claim that he has not entered into an impermissible avoidance arrangement.

After hearing the taxpayer, the CIT would pass an order³⁵ either declaring an arrangement to be an ‘impermissible avoidance arrangement’ or not. Where the arrangement is declared as an ‘impermissible avoidance arrangement’, the CIT would (i) issue directions to the AO to make adjustments to the taxpayer’s income and tax liability; and (ii) forward a copy of his order to the jurisdictional CIT of the other party to the arrangement to proceed against that party under the GAAR provisions.

The order of the CIT cannot be issued beyond twelve months from the end of the month in which the notice was issued to the taxpayer³⁶

³² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations- July 2010, para 1.65

³³ Transactions between two enterprises that are AEs with respect to each other

³⁴ Section 154(1) of the Code

³⁵ Section 154(2) of the Code

³⁶ Section 154(4) of the Code

4.9. Analysis of the procedural provisions

The power to invoke the GAAR exclusively rests with the CIT. The CIT also has the administrative jurisdiction with revenue budget targets to meet. Additionally, the CIT, being a Revenue official, would generally like to err in favour of the Revenue rather than taking decisions in favour of the taxpayer. The experience in revision proceedings under the current law is a case in point. It would therefore be effective and judicious if the power of determination of an arrangement is given to an independent Authority or to a GAAR Panel consisting of experts including from the Revenue Department. The CIT would recommend the case to the GAAR Panel for its consideration.

The proceedings must also be conducted under the principles of natural justice. The notice should clearly specify the information and the reasons leading to the initiation of GAAR proceedings against the taxpayer. Further, any additional information coming to the notice of the CIT after initiation of the proceedings also needs to be communicated to the taxpayer. The taxpayer should be issued with a show cause notice before conclusion of the proceedings so that the taxpayer can appropriately respond.

The draft section only provides for limitation for issue of the order by the CIT, from the date of issue of notice. It is necessary to provide the time limit for the issue of a notice under section 154 of the Code.

Based on the directions of the CIT under the GAAR provisions, the AO is required to pass a draft order. The taxpayer can file objections to the DRP against the adjustment proposed in the draft order, including on the matters arising out of application of GAAR provisions. It is critical that the authority to which the objections are filed should be comprised of people who are independent of the tax department and have commercial experience. The DRP should therefore be made independent and should operate along the lines of the ITAT.

The other issue of paramount importance is the applicability of the GAAR to transactions entered into before the GAAR provisions are enacted. The Code does not provide any start date for application of the GAAR provisions vis-à-vis the date on which the scheme was entered into. Under the Australian GAAR, provisions³⁷ were incorporated in the law which specifically provided that the GAAR provisions would apply to Schemes entered into on or after the date of introduction of the Australian GAAR in 1981. Similar restrictions were spelt out in a circular³⁸ by the Canadian Revenue Authorities when Canadian GAAR was introduced in 1988.

Section 154(3)(b)(ii) of the Code requires the CIT to forward a copy of the GAAR order to the jurisdictional CIT of the other party to the arrangement, so that GAAR proceedings can be initiated against the other party.

It is not clear from the law whether the proceedings against the other party would only take place where further taxes can be recovered from him. To avoid double jeopardy, where GAAR is invoked on one party to the arrangement, the other party should be statutorily granted relief for any tax paid by him on such transaction.

The scope of Advance Rulings under the Code does not include examination of transactions under GAAR provisions. It is necessary for taxpayers to know authoritatively the implications under GAAR provisions. This would provide certainty to taxpayers while entering into transactions, especially large ones, which are also resulting in tax benefits.

From the above analysis, it is evident that the GAAR provisions, if enacted in the present form, will have far reaching consequences and uncertainty in terms of tax implications of various business and non-business arrangements.



37 Section 177D of the Australian Income-tax Assessment Act, 1936

38 IC 88-2 – General Anti-avoidance Rule: Section 245 of the Income Tax Act issued on 21 October, 1988

5. GAAR and treaty override

The Code stipulates³⁹ that the GAAR provisions shall override the provisions of any Double Taxation Avoidance Agreement (Tax Treaty) that India may have entered into. The Discussion Paper 2009, introducing the provisions of GAAR highlighted the overriding power of GAAR over the tax treaties. The relevant extracts of the Discussion Paper are as follows:

Treaty Override

24.11 Under the Vienna Convention, international agreements are to be interpreted in ‘good faith’. In case any international agreement/treaty leads to unintended consequences like tax evasion or flow of benefits to unintended person, it is open to the signatory to take corrective steps to prevent abuse of the treaty. Such corrective steps are consistent with the obligations under the Vienna Convention. Further, the OECD Commentary on Article 1 of the Model Tax Convention also clarifies that a general anti-abuse provision in the domestic law in the nature of “substance over form rule” or “economic substance rule” is not in conflict with the treaty. **The general anti-abuse rule will override the provisions of the tax treaty. The Code provides accordingly.**

The Discussion Paper also states that the CIT would be empowered to “disregard the provisions of any agreement entered into by India with any other country”⁴⁰ while determining the tax consequences of impermissible avoidance agreements.

The Discussion Paper has also drawn support from the provisions of the Vienna Convention and the OECD Model Convention (OECD MC). The provisions of the Vienna Convention, the OECD Model Convention, and the UN Model Convention (UN MC) in this regards are as follows:

5.1. Vienna Convention

Tax treaties are governed by the Vienna Convention⁴¹. Though India has neither signed nor ratified the Vienna Convention, yet its guiding principles can be found in the Discussion Paper. The provisions of the Vienna Convention clearly emphasise that a treaty should be interpreted and must be performed by parties to it in “good faith”. Some of the significant Articles of the Vienna Convention which have bearing on our discussion are enumerated below:

Preamble of Vienna Convention	The parties to the Convention have noted that the principles of free consent and of good faith and the pacta sunt servanda rule ⁴² are universally recognised.
Article 18	Casts an obligation on parties to the Convention not to defeat the object and purpose of a treaty.
Article 26	Lays down the principles of pacta sunt servanda, which states that every treaty in force is binding upon the parties to it and must be performed by them in good faith.
Article 27	Lays down the principles of internal law and observance of treaties and states a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.
Article 31	Lays down the general rule of interpretation of treaty, and stipulates that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
Article 46	“Provisions of internal law regarding competence to conclude treaties” provides that a State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance. It further provides that a violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

39 Section 291(9) of the Code

40 Para 24.9(ix) of the Discussion Paper 2009

41 Vienna Convention on the Law of Treaties was signed in Vienna on 23 May 1969 and entered into force on 27 January 1980.

42 Promises must be kept. An expression signifying that the agreements and stipulations of the parties to a contract must be observed

In a nutshell, according to the Vienna Convention:

- **Existing domestic law v. existing treaty** - The principle of “pacta sunt servanda” incorporated in Article 26 of the Vienna Convention suggests that in case of conflict between the provisions of tax treaties and those of domestic law, the provisions of the tax treaties must prevail. A conjoint and proper construction of Article 18, Article 26 and Article 31 of the Vienna Convention suggests that circumstances or situations like “tax abuse” may amount to abuse of the Convention itself and therefore such abusive transactions should be disregarded while granting benefits under the treaty.
- **Existing treaty v. subsequent domestic law changes** - Under the Vienna Convention, technically, any unilateral act on the part of a country to override existing tax treaties, through the later insertion of provisions in domestic tax laws, may be in conflict with Articles 18 and 26 of the Convention, which cast an obligation on the parties to respect the Convention. Further, Article 27 of the Convention provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This means that a party may not invoke its domestic legislation that was enacted after a treaty agreement was concluded. A treaty is generally understood to be a contract and has the effect of binding the two contracting States to that agreement. Any domestic law subsequently enacted to combat tax avoidance may not override such a binding legal agreement. An alternative argument advanced against this principle is that such anti abuse measures are inherent in the application of treaty, relying on the principles of ‘good faith’ and ‘not to defeat the object and purpose of a treaty’.

5.2. OECD Model Convention

The 2010 Commentary (Commentary) to Article 1 of the OECD MC discusses the relationship between domestic anti-avoidance rules and treaty and whether treaties benefits would be available with respect to abusive transactions. It clarifies that apart from the principal purpose of tax treaties which is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons, **prevention of tax avoidance and evasion** is also a purpose.

The relevant extracts of the Commentary to Article 1 are reproduced below:

7.1 Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries’ laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral tax treaty that would have the effect of allowing abusive transactions that would otherwise be prevented by the provisions and rules of this kind contained in its domestic law. Also, it will not wish to apply its bilateral tax treaties in a way that would have that effect.

8. It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in the double tax conventions.

9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13) transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.

The Commentary raises two fundamental questions:

1. Whether the benefits of tax treaties must be granted when transactions that constitute an abuse of the provisions of these treaties are entered into; and
2. Whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax treaties.

In a nutshell, under both approaches, therefore, it is agreed that States do not have to grant the benefits of a tax treaty where arrangements that constitute an abuse of the provisions of the tax treaty have been entered into.

Approach 1

For many States the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. **Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied.** For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the second question above.... the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. **Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.**⁴³

Approach 2

Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).⁴⁴

The Commentary on Article 1, further states:

9.5 A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts view described in paragraph 9.2 above believes that its domestic law lacks the anti avoidance rules or principles necessary to properly address such strategy.

Provisions which are aimed at preferential regimes introduced after signature of the convention

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including “substance-over-form”, “economic substance” and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is second question mentioned in para 9.1 above

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the convention will be applied taking into account these changes.

22.2 Whilst these rules do not conflict with tax conventions, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.

⁴³ Extract from para 9.2 of Article 1 of the Commentary

⁴⁴ Extract from para 9.3 of Article 1 of the Commentary

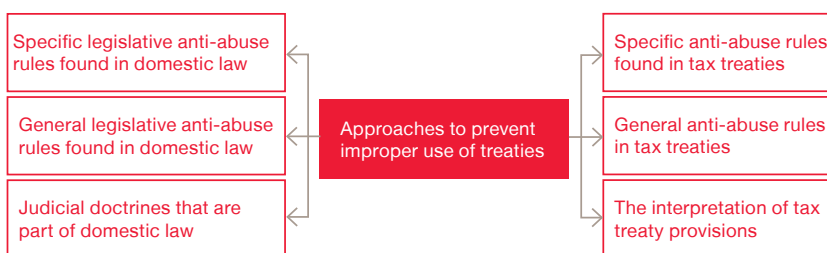
One may note that certain countries like Luxembourg, the Netherlands and Switzerland have expressed their reservations on the principle laid down in the 2010 Commentary that domestic anti-avoidance provisions do not conflict with the treaties.

In a nutshell, the views of OECD can be summed up as follows:

- The domestic GAAR may not conflict with the treaty.
- Specific provisions in the treaty can be used in conjunction with (or can usefully supplement) the domestic GAAR to prevent treaty abuse. Such specific provisions can be adopted if a country feels that its domestic GAAR lacks the principles necessary to address properly any specific abuse strategy. Furthermore, Limitation of Benefit (LOB) clauses address the specific conduit entity situations and do not cover all abusive situations.

5.3. United Nation Model Convention

Committee of Experts on International Cooperation in Tax Matters, UN (Committee) in its Report, issued during its fourth session in Geneva on 20 -24 October 2008 states that there are a number of different approaches used by countries to prevent and address the improper use of tax treaties. These include:



The relevant extracts of changes to the Commentary to Article 1 of the UN MC 2001, approved by the Committee are reproduced below:

Specific legislative anti-abuse rules found in domestic law

12. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

14 A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is that of possible conflicts with the provisions of tax treaties. Where two Contracting States take different views as to whether a specific anti-abuse rule found in the domestic law of one of these States conflicts with the provisions of their tax treaty, the issue may be addressed through the mutual agreement procedure having regard to the following principles.

15. Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of “pacta sunt servanda” which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of these rules had the effect of increasing the tax liability of taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions would prevail under public international law.

16 As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances.

17 First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorises the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalisation rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

18 Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

19 Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

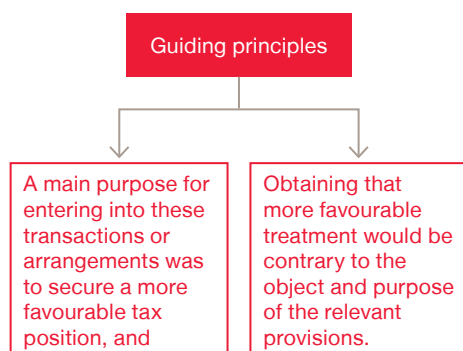
General legislative anti-abuse rules found in domestic law

20 Some countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific rules or judicial doctrines.

21 As is the case for specific anti-abuse rules found in domestic law, the main issue that arises with respect to the application of such general anti-abuse rules to improper uses of a treaty is that of possible conflicts with the provisions of the treaty. *To the extent that the application of such general rules are restricted to cases of abuse, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in paragraph 22 and 22.1 of the Commentary on Article 1 of the OECD Model with which the Committee agrees.*

The Committee considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. They emphasised that, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

The Committee reiterated the OECD guiding principle that two elements must be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty



They indicated that these two elements will also often be found, explicitly or implicitly, in general anti avoidance rules and doctrines developed in various countries. In order to minimise the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not the alleged intention of the parties. Thus, the

determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

According to the Committee:

36 A country that would not feel confident that its domestic law and approach to the interpretation of tax treaties would allow it to adequately address improper uses of its tax treaties could of course consider including a general anti-abuse rule in its treaties. The guiding principle referred to above could form the basis for such a rule. which could therefore be drafted along the following lines:

“Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.”

When considering such a provision, some countries may prefer to replace the phrase “a main purpose” by “the main purpose” to make it clear that the provision should only apply to transactions that are, without any doubt, purely tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as “the main purpose” would impose an unrealistically high threshold that would require tax administrations to establish that obtaining tax benefits is objectively more important than the combination of all other alleged purposes, which would risk rendering the provision ineffective. A State that wishes to include a general anti-abuse rule in its treaties will therefore need to adapt the wording to its own circumstances, particularly as regards the approach that its courts have adopted with respect to tax avoidance.

37 Many countries, however, will consider that including such a provision in their treaties could be interpreted as an implicit recognition that, absent such a provision, they cannot use other approaches to deal with improper uses of tax treaties. This would be particularly problematic for countries that have already concluded a large number of treaties that did not include such a provision. For that reason, the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The above extracts and views of the UN MC suggest that they are primarily in agreement with the views of the OECD that domestic anti-avoidance rules in principle do not conflict with the treaty provisions.

The table below summarises the view of the OECD and the UN MC on treaty override.

Further, Indian Treaties do not have a GAAR and few have a LOB Article. The Supreme Court in the case of *Azadi Bachao Andolan*⁴⁵ held inter alia that in the absence of an LOB in the treaty, the treaty would prevail. The Supreme Court reiterated this principle in *Vodafone's* case, opining that LOB has to be expressly provided for in the treaty and cannot be read into the provision by interpretation.

It is therefore doubtful as to how an action by the Revenue Authorities in denying treaty benefit by disregarding the beneficial provisions of a treaty (which does not specifically have an LOB clause), would be tenable in law, especially in the case of genuine strategic tax planning. The proposed GAAR provisions empowering the Revenue Authorities to override beneficial treaty provisions would have to be read down to apply only in cases of fraud, sham or tax avoidant devices.

Particulars	OECD MC	UN MC (Committee Report)
<i>Whether treaty benefits could be granted in case of abusive transactions</i>	No	No
<i>Whether application of domestic GAAR conflicts with treaty provisions</i>	No	No. To the extent application of GAAR is restricted to cases of abuse discovered on the basis of objective determination.
<i>Whether Specific LOB in treaty would prevent application of domestic GAAR</i>	LOB can usefully supplement a domestic GAAR.	LOB may not provide a comprehensive solution. In case LOB deals with specific abuse (say conduit entities), then the domestic GAAR may also apply to prevent other abuses, not covered by the treaty.

⁴⁵ *Azadi Bachao Andolan v. Union of India* [2003] 263 ITR 706 (SC)

6. Recommendations

6.1. Background

As discussed earlier, the scope of the proposed GAAR provisions is exceptionally wide. The introduction of the GAAR in the present form is likely to create uncertainty about the tax implications of various business and non-business transactions / arrangements. This would not only create practical difficulty for the taxpayers, in the current economic scenario, such provisions could create a negative environment against the efforts of increasing domestic as well as foreign inward investments. The Supreme Court has in Vodafone's case also observed that Foreign Direct Investment (FDI) *"flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws."* A holistic view, therefore, needs to be taken in the matter.

Therefore, the proposal on GAAR provisions needs to be considered in this context and viewed from this larger angle. The moot question arises is whether, at this stage, the approach of introducing the GAAR in the Indian Tax Law is correct or whether it is better to adopt a targeted approach and expand the scope of SAARs. If it is felt necessary to introduce GAAR provisions, a further question which needs consideration is, whether it is wise to introduce these in the present form in the Indian tax scenario. The recommendations given in this Chapter should also be viewed against this background.

6.2. Introduction of an anti-avoidance rule

6.2.1. Practical and reasonable approach – Deferral of GAAR

The current GAAR provisions appear to have been conceived primarily from the Revenue angle. The better approach would be to involve all the stake holders in conceiving and formulating such provisions having far-reaching implications. This will address the genuine concerns of all stakeholders. Internationally, such a practice is followed in major countries. Therefore, on an alternative basis, it is worth considering constituting an Expert Committee consisting of representatives of the business community, professionals from Direct Tax field and Revenue Department along the lines of the Choksey Committee which was formed in the past. Such a committee should objectively examine the proposed GAAR provisions at macro as well as micro level and consider their long-term implications. Such a committee should consider the feasibility of introduction of a broad spectrum GAAR and determine the scope of the provisions thereof with appropriate safeguards and the manner of its implementation.

At the initial stage of introducing any Anti-avoidance Rule, it would be better to introduce SAARs with reference to certain specific arrangements which the Government may have perceived to be tax avoidance arrangements and confine the application of Anti-avoidance Rule to such cases. As against a GAAR, specific rules (SAAR) give confidence to the taxpayers and also help in reducing litigation.

As mentioned earlier, in the report submitted by Graham Aaronson (Queens Counsel) to the UK Government on the feasibility of introduction of a GAAR it has been observed that a broad spectrum GAAR would undermine certainty and make the UK less attractive to multinationals. The report concludes that a

broad spectrum GAAR would not be beneficial for the UK tax system as it would carry “a real risk of undermining the ability of business to carry out sensible and responsible tax planning”. However, the report says that introducing a moderate rule which does not apply to reasonable tax planning, and instead targets abusive arrangements, would be beneficial.

In the Indian context it is recommended that a targeted approach could be adopted by expanding SAARs instead of introducing a broad based GAAR. The application of the law should be to specific arrangements and not open ended.

6.2.2. Alternative Approach

Targeted Approach

In the past, the SAARs were introduced from time to time and a targeted approach was adopted to fill in the gap, whenever a lacuna was found or difficulties were encountered in checking tax avoidance. This approach was balanced and found to be effective. While it has created a certain amount of uncertainty on implementation, by and large, by now, the principles governing the SAAR are getting settled. Therefore, SAARs have not worked adversely and this approach has also reduced, to a large extent, uncertainty for business. However, this took a long time to materialise. This approach and experience could be a good guide for determining the need for introduction of the GAAR and the manner of its implementation.

Phased introduction of GAAR

If it is considered that SAARs would not be sufficient and it is considered necessary to introduce a GAAR it would be a better approach to introduce it in a phased manner. The scope of the GAAR provisions should be limited in the initial years to gain experience of its implementation. Gradually, as and when need arises, the scope of such provisions can be expanded. At the initial stage, GAAR provisions could be confined to high value international transactions with AEs. With experience, one may consider expanding the scope to include high value domestic transactions with AEs. Thereafter, once the general principles governing the GAAR provisions

are settled in the context of their understanding and implementations, and after considering their impact on various stakeholders, the business environment, investment climate etc., the Government could consider the need for further expanding the scope of the GAAR provisions. In any case, the GAAR provisions should always be restricted only to transactions with AEs and not include transactions with third parties.

Further, the Government should notify the types of arrangements which are to be considered as tax avoidance arrangements. The proceedings for invoking GAAR provisions should be permitted to be initiated only in the case of such notified types of arrangements. The list of such notified arrangements can be reviewed from time to time and modified / expanded as necessary.

6.3. Recommendation on draft legislation

6.3.1. Substantive provisions

Presumption and onus of proof

The onus is on the assessee to prove that tax benefit was not the main purpose of an impugned arrangement. An anti-abuse provision which shifts the entire burden of proof on the assessee would be very difficult for the taxpayer in practice as he has to prove a negative assertion, especially in complex commercial arrangements. This would be against the principles laid down by English Courts in various decisions as well in the Supreme Court of India.

It is, therefore, recommended that the initial burden of proof of the allegation that the arrangement was not entered into with a commercial purpose but a preordained colourable or artificial device with the sole purpose of obtaining a tax benefit should be on the Authority. The taxpayer's responsibility in such a case would be to prove that the arrangement was entered into mainly for a commercial purpose. Further, it should be made mandatory for the Authorities to establish the critical test

based on facts and evidence to be obtained from the taxpayer.

Limiting definition of Impermissible Avoidance Arrangement

GAAR provisions would under the current proposal, be triggered if the main purpose of any arrangement including that of a step therein is to obtain tax benefit. It is recommended that ‘main purpose’ should be substituted by ‘sole purpose’ of the arrangement to obtain tax benefit. This will make the provisions workable. A similar concept ‘wholly or almost wholly’ is already prevalent.

Limiting the scope of application of GAAR

The scope of the GAAR provisions in Section 123(1) of the Code in terms of the tests applicable is very wide. The definitions of key terms like ‘arrangement’, ‘impermissible avoidance agreement’, ‘tax benefit’ are wide as well. Some of the terms like ‘bona fide purpose’ are defined in such a way that they are negative in nature and restrict the ability of the taxpayer to prove the genuineness and commercial reason for entering into an arrangement.

In view of the above, it is recommended that –

- a. The wide application of the GAAR under section 123(1) of the Code should be rationalised. The power to rationalise the provisions should not be delegated to an executive authority. The provisions for rationalisations should be included, by the legislature, in the Code itself. This would bring about certainty in the GAAR provisions.
- b. The definition of key terms like ‘impermissible avoidance arrangement’ should be made specific rather than keeping them vague and open.
- c. The critical tests for ‘impermissible avoidance arrangement’ should be reduced to ‘lack of commercial substance’ and ‘absence of bona fide purpose’ only. Further, where necessary, the tests should be defined objectively rather than leaving them subjective and open to misuse.

- d. Negative, round-tripping definitions like ‘bona fide purpose’ should be deleted.
- e. Transactions with ‘commercial substance’ should be specifically excluded from the scope of GAAR even if they result in tax mitigation. ‘Commercial substance’ should be judged from the businessman’s point of view and not from the subjective point of view of the Authorities.
- f. Consequences of GAAR – Recharacterisation of transactions should be avoided and should not affect the other party’s rights and obligations, especially non residents. The tax benefit of transactions can be denied instead of recharacterisation. Further, to avoid double jeopardy, where tax benefits are denied to a party to an arrangement, the levy of tax on the other party / accommodating party should be negated.

6.3.2 Treaty Override

The GAAR provisions should not override treaty provisions where a specific LOB clause exists in the tax treaty or LOB conditions are specified through Protocol or Memorandum of Understanding. The denial of treaty benefits in the case of such treaties should be governed by the LOB clause.

As held by the Supreme Court in Vodafone’s case(above), in the absence of a specific LOB clause, treaty benefits cannot be denied to genuine transactions. GAAR provisions therefore should be restricted to cases of treaty abuse through sham preordained colourable devices determined on objective basis.

Specific conditions / situations / transactions / circumstances should be specified in the Code for which treaty override can be applied.

6.3.3 Procedural Provisions

GAAR Panel – Instead of the power to invoke the GAAR resting with the CIT, a GAAR Panel, consisting of experts, including from the Revenue Department, should be set up to administer the GAAR.

Limitation – The period of limitation for issuing a notice initiating GAAR proceedings should be incorporated in the Code.

Principles of natural justice –

- a. The notice initiating the GAAR proceedings should specify the information and reasons for initiation of proceedings. Any further information collected by the Authorities should be communicated to the taxpayer
- b. The taxpayer should be issued a show cause notice before conclusion of the proceedings.

DRP – The DRP should be made independent consisting of experts including from the Revenue Department and should function like the ITAT.



6.3.4 Measures for certainty

a. Authority for Advance Ruling (AAR) –

The scope of the AAR should include matters and questions on the GAAR so that taxpayers can approach the AAR with proposed transactions to obtain certainty from a GAAR perspective.

b. Prospective application –

The GAAR provisions, if introduced should be made prospective in nature inasmuch that transactions entered into, structures created and investments made before introduction of GAAR provisions should be kept outside the purview of the GAAR.

c. The following types of transactions or arrangements should be specifically exempted from application of the GAAR

- where the tax effect is less than the prescribed amount (i.e. threshold limit)

- transactions or arrangements similar to the one in respect of which Advance Ruling has been obtained by the assessee and there is no material difference between the transactions / arrangements
- cases which have been subjected to transfer pricing scrutiny and found to be compliant
- where the arrangement is entered into by the assessee with a view to obtaining the benefit of a special tax deduction/exemption/incentive provided under the provisions of the Code eg. setting-up an undertaking in the area where a tax holiday is available
- where a bonafide arrangement is carried out under the provisions of any other law for the time being in force

- if a particular arrangement has been subject to normal assessment for the last three years and has been accepted as a genuine commercial arrangement, then this should not be reviewed under the GAAR provisions so long as there is no material change in the facts or law.



Annexure A

The Vodafone Ruling⁴⁶

Laying down the anti-avoidance perspective⁴⁷

Facts

- The Hutchison Group (Hong Kong) had acquired interests in mobile telecommunications industry in India from 1992 onwards and over a long period of time, a large and complicated ownership structure evolved. The Hutchison Group had an interest in the Indian operating company Hutchison Essar Ltd (HEL) through a number of overseas holding companies. HEL had further step down operating subsidiaries in India.
- The majority of the share capital of HEL, which was under the direct or indirect control of Hutchison Group, was held by various Mauritius/Indian companies, which in turn were held by Mauritian/Cayman Islands companies.
- Hutchison held certain call and put options (representing 15% of the shareholding of HEL) over companies controlled by other persons. These options were in favour of 3Global Services Pvt. Ltd. (3GSPL), an Indian company, against consideration of credit support.
- In late 2006, Hutchison Telecommunications International Ltd., Cayman Islands (HTIL) received various offers from potential buyers to acquire its equity interest in HEL including one from Vodafone Group Plc, who made a non-binding offer for 67% of HEL for a sum of USD 11.076 billion, based on an enterprise value of USD 18.8 billion of HEL.
- A sale purchase agreement (SPA) was entered into on 11 February, 2007 between VIH and HTIL, under which VIH was to acquire the sole share of CGP Investment (Holdings) Ltd., a Cayman Islands company (CGP).
- Subsequently, on 20 February, 2007 VIH filed an application under Press Note 1 of 2005 for an approval from Foreign Investment Promotion Board (FIPB) and for FIPB to make a noting of the transaction. On 7 May, 2007, FIPB granted approval to VIH and on 8 May, 2007, VIH paid over the consideration.

Issue

The controversy in this case centred on the taxability in India of the offshore transfer of shares in CGP, a Cayman Islands Company by the Hutchison Group to the Vodafone Group. The Indian Revenue Authorities contended that in view of the substantial underlying assets in India, in the form of HEL and its business, the transfer was not of the share of CGP but in substance that of the underlying Indian assets. Accordingly, the capital gain arising from the transfer was taxable in India and VIH was liable to withhold tax from the consideration payable to HTIL.

The issues before the Supreme Court were as follows:

- Were the gains arising on the sale of CGP taxable in India?
 - Where was the situs of the shares of CGP?
 - Did the transaction result in transfer of any asset in India?
- Was VTIL liable to withhold Indian tax from the consideration?

The Ruling

The Supreme Court held as follows:

- Gains arising on sale of the share of CGP were not taxable in India
 - The share of CGP was situated outside India (i.e., in the Cayman Islands)
 - The transaction did not result in the transfer of any asset in India
- VTIL was not liable to withhold tax from payment of the sale consideration for acquisition of CGP.

⁴⁶ SLP (C) No. 26529 of 2010, Judgement dated 20 January, 2012

⁴⁷ This note highlights the key principles on anti-avoidance discussed and laid down by the Supreme Court in Vodafone's case (above)

Key principles and observations on anti-avoidance

In its ruling, the Supreme Court made significant observations relating to tax avoidance, international tax structures and anti-avoidance regulations. The Court laid down some key principles on this subject and reiterated others. These are as follows:

General

- The concept of GAAR is not new to India, which already has a judicial anti-avoidance rule, like some other jurisdictions.
- The English Courts have in its their rulings in the Duke of Westminster's case⁴⁸ and subsequent decisions in Ramsay's case⁴⁹ and Craven v. White⁵⁰ laid down principles on anti-avoidance. The cardinal Westminster principle states that *given that a document or a transaction is genuine, the Court cannot go behind it to some supposed underlying substance*. Interpreting and following this cardinal principle, the English Courts have held in subsequent rulings that *the Revenue cannot start with the question as to whether the transaction was a tax deferment or saving device but that the revenue should apply the 'look at' test to ascertain its true legal nature. It is the task of the Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach*. It has been a cornerstone of law that a taxpayer is entitled to arrange his affairs so as to reduce his tax liability; the fact that

the motive for a transaction is to avoid tax does not invalidate it unless a particular enactment so provides. Genuine strategic planning is permissible.

- In McDowell's case⁵¹, the Supreme Court held that *tax planning may be legitimate provided it is within the framework of law*. However a *colourable device cannot be a part of tax planning*. The separate ruling given one of the Hon'ble judges (Reddy, J.) was in relation to tax evasion through colourable devices by resorting to dubious methods and subterfuges. Nowhere is it mentioned that tax planning is illegitimate or impermissible and, moreover, Reddy, J. himself noted that he agreed with the majority ruling.
- Reading McDowell's case in the above manner, in cases of treaty shopping or tax avoidance there is no conflict between the ruling of the Apex Court in McDowell's case and in its subsequent rulings in Azadi Bachao Andolan's case⁵² or Mathuram Agrawal's case⁵³.
- Courts have evolved doctrines such as piercing the corporate veil, substance over form etc. enabling taxation of underlying assets in cases of fraud, sham, tax avoidant etc. However genuine tax planning is not ruled out.
- The question of providing 'look through' in the statute or in a treaty is a matter of policy. It is to be expressly provided in the statute and cannot be read into the section by interpretation. Similarly, LOB has to be expressly provided for in the treaty⁵⁴.

International holding structures

- The law of corporate taxation is generally founded on the 'separate entity principle' by which a company is treated as a separate person capable of legal independence vis-à-vis its shareholders/participants. The fact that a parent company exercises shareholder's influence on its subsidiaries does not imply that the subsidiaries are to be deemed residents of the State in which the parent company resides.
- It is a common practice for foreign investors to invest in Indian companies through an interposed foreign holding or operating company, such as a Cayman Islands or Mauritius based company for both tax and business purposes. This is to avoid the lengthy approval and registration processes required for a direct transfer of an equity interest in a foreign invested Indian company.
- Holding structures are recognized in corporate as well as tax laws. Special Purpose Vehicles (SPVs) and Holding Companies have a place in legal structures in India – under company law, SEBI regulations or under the income tax law. When it comes to taxation of a Holding Structure, at the threshold, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s). In the application of a judicial anti-avoidance

48 *The Commissioners of Inland Revenue v. His Grace the Duke of Westminster* [1935] All E.R. 259

49 *W.T. Ramsay Ltd. v. IRC* [1981] 1 All E.R. 865

50 *Craven v. White* [1988] 3 All E.R. 495

51 *McDowell & Co. Ltd. v. C.T.O.* [1985] 154 ITR 148 (SC)

52 *Azadi Bachao Andolan v. Union of India* [2003] 263 ITR 706 (SC)

53 *Mathuram Agrawal v. State of Madhya Pradesh* [1999] 8 SCC 667

54 *The Supreme Court held that the India-Mauritius tax treaty which does not have an LOB clause, does not restrict the benefit (of capital gains tax exemption) to companies whose shareholders are non-citizens/residents of Mauritius or where the beneficial interest is owned by non-citizens/residents of Mauritius. Therefore, there is no justification in prohibiting the residents of a third nation from incorporating companies in Mauritius and deriving benefit under the treaty.*

rule, the Revenue may invoke the 'substance over form' principle or the 'piercing the corporate veil' test only after it is able to establish, on the basis of the facts and circumstances surrounding the transaction, that the impugned transaction is a sham or tax avoidant. For example, if a structure is used for circular trading or round tripping or to pay bribes, then such a transaction, though having a legal form, should be discarded by applying the test of fiscal nullity.

- There is a conceptual difference between a "preordained transaction" created for tax avoidance purposes and one which evidences "investment to participate" in India. Strategic Foreign Direct Investment coming to India as an investment destination should be seen in a holistic manner. When doing so, the Revenue/Courts should keep in mind the following factors:
 - i. the concept of participation in investment;
 - ii. the duration of time during which the Holding Structure exists;
 - iii. the period of business operations in India;
 - iv. the generation of taxable revenues in India;
 - v. the timing of the exit;
 - vi. the continuity of business on such exit.

The corporate business purpose of a transaction is evidence of the fact that the transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device.

Indirect transfer – looking through transactions

- Section 9(1)(i) of the Act, applies to transfer of capital assets situate in India. It does not cover indirect transfer of a capital asset. Reading so, the words capital asset situate in India in section 9(1)(i) would be rendered nugatory. Similarly, the words, 'underlying asset' do not find a place in the said section. By contrast, the Code proposes to tax offshore share transactions in specified cases. This shows that indirect transfer cannot be read into section 9(1)(i) of the Act.
- Shareholdings in companies incorporated outside India is property situate outside India. When such shares become the subject matter of an offshore transfer between two non-residents, there is no liability for capital gains tax in India. A transaction has to be viewed from a commercial and realistic perspective and it has to be determined whether it is a 'share sale' or an 'asset sale' because the tax consequences of a share sale would be different from the tax consequences of an asset sale. A transaction involving transfer of shares lock, stock and barrel cannot be broken up into separate individual components, assets or rights such as the right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licences and so on, as shares constitute a 'bundle of rights'. Even when the purchaser pays a consideration to the vendor based on the enterprise value of the Indian assets, valuation cannot be the basis of taxation. Section 9 cannot be applied only on the basis that the value of foreign company's shares was made up by the underlying Indian assets.

Certainty in Tax Policy

- FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner. It is for the Government of the day to have them incorporated in the Treaties and in the laws so as to avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws.

Annexure B

International perspectives on GAAR

Australia

1. An Overview

Part IVA of the Income Tax Assessment Act 1936 (ITAA) operates as Australia's primary tax anti-avoidance regime which commenced in 1981. It applies to schemes entered into after 27 May 1981. It applies whether a scheme is carried out in Australia or abroad.⁵⁵

There are three key elements which govern its applicability being (a) the presence of a scheme (b) the presence of a tax benefit; and (c) the dominant purpose of the taxpayer or one of its advisors in entering into that scheme. If it is found that the dominant purpose of the scheme was indeed to achieve a tax benefit the Commissioner may cancel the tax benefit in accordance with section 177F of the ITAA. Unlike its predecessor section 260 of the ITAA, Part IVA will apply to cancel the benefit obtained by the taxpayer. Further, part IVA has the effect of imposing tax in circumstances where, having regard to all of the other provisions of the Act, such taxation would not otherwise apply. To this end, Part IVA operates as a provision of last resort and, where it is found to apply, will result in:

- The inclusion of an amount of income where that amount would have been included, or might reasonably have been included, if the scheme had not been entered into;
- The denial of a deduction where that amount would not have been allowable, or might reasonably be expected not to be allowable, if the scheme had not been entered into;

- The denial of a capital loss incurred where that amount would not have been or might reasonably be expected not to be incurred if the scheme had not been entered into
- The denial of a foreign income tax offset where that amount would not have been allowable, or might reasonably be expected not to be allowable, if the scheme had not been entered into.

The Explanatory Memorandum to the Tax Laws Amendment Act (No. 2) 1981 which introduced Part IVA stated that the new provisions were only intended to apply to those arrangements which were generally of a “blatant, artificial or contrived kind” and in particular not “arrangements of a normal business or family kind, including those of a tax planning nature”. The Second Reading Speech went further, stating that Part IVA's operation was specifically designed to “not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs”⁵⁶. The Courts however have given a broader application to the interpretation of Part IVA than simply to blatant, artificial or contrived arrangements

2. Anti-avoidance Provisions

Generally speaking, Part IVA will only apply to a scheme if the answer to the following questions is in affirmative:

1. Did you obtain a tax benefit?
2. Was that tax benefit derived from a

scheme – a benefit that would not have been available if the scheme had not been entered into?

3. Having regard to the eight matters specified in Part IVA, would it be objectively concluded that you or any other person entered into or carried out the scheme, or any part of it, for the sole or dominant purpose of obtaining the tax benefit?

What is Scheme?⁵⁷ (Similar to term “Arrangement” in Indian context)

Scheme means:

- a. any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- b. any scheme, plan, proposal, action, course of action or course of conduct.

The definition of a scheme is very broad. It encompasses not only a series of steps which together constitute a scheme or ‘plan’, but also (by reference to ‘action’) taking of just one step. Since the term ‘scheme’ is very wide, it is usually more important to work out if a tax benefit was obtained in connection with it.

Tax benefit⁵⁸

The main kinds of tax benefit are an amount not being included as assessable income, or a deduction, capital loss or foreign tax credit being allowed. Part IVA applies on the basis that but for Part IVA the tax benefit is legally available under the Act, ie. it is a provision of last resort.

⁵⁵ Section 177D of the ITAA

⁵⁶ Income Tax Laws Amendment Act (No. 2) 1981, Second Reading Speech, the Hon. John Howard, M.P

⁵⁷ Section 177A of the ITAA

⁵⁸ Section 177C(1) of the ITAA

The determination of whether there is a tax benefit under section 177C(1)(b) and its quantum, requires a determination of whether and the extent to which, if the scheme had not been entered into what might reasonably be expected to have occurred. This requires a prediction as to events which might have taken place if the relevant scheme had not been entered into, which is referred to in the cases as the counterfactual, alternative hypothesis or the alternative postulate⁵⁹. A tax benefit can only arise where:

- a. There is a counterfactual which is reasonable; and
- b. That counterfactual gives rise to a higher tax cost than the scheme entered into.

To determine whether the tax benefit was identified in connection with the scheme requires there to be a comparison “between the scheme in question and an alternative postulate.”⁶⁰

In *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd (Ashwick)*⁶¹ the Court stated the following general propositions in order to *establish a counterfactual*:

- The focus of section 177C is the identification of an activity, that is, the **prediction of events** that would have or might reasonably have been expected to have taken place in the absence of the scheme.
- It is an **objective fact** whether a taxpayer obtained a tax benefit in relation to a scheme to which Part IVA applies.
- **When predicting events** which would or might have taken place, the question is assessed on the assumption that the scheme had not been entered into or carried out. Additionally, there must be an objective enquiry of predicting the particular activity or the events that might reasonably be expected to have taken place in the absence of the scheme.
- The taxpayer’s **actual rejection** of a counterfactual at the relevant time will be important evidence in determining what would have been expected to occur.

- In a **deduction case**, if it can be predicted that the relevant scheme had not been entered into or carried out, the taxpayer would have done something which would give rise to a deduction being allowable to it of an equivalent amount, and the prediction is sufficiently reliable to be regarded as reasonable, there will be no tax benefit.

Part IVA allows the Commissioner to cancel the effects of the tax benefits which a taxpayer obtains in connection with the scheme⁶². The Australian GAAR overrides the Treaty provisions. Part IVA is not limited by provisions in the ITAA or by the International Tax Agreements Act 1953⁶³.

Dominant Purpose

To conclude objectively that the person entered into the scheme or carried out the scheme, or any part of it, for the sole or dominant purpose of obtaining the tax benefit, the eight matters examined are⁶⁴:

1. The **manner** in which the scheme was entered into or carried out – is it contrived to obtain tax benefits? E.g., it would be relevant if there are steps in the transaction or arrangement that would not be expected to be found in a more straightforward method of achieving the outcome. The presence of these steps adds weight to the view that the purpose of the transaction or arrangement was to obtain the tax benefit.
2. The **form and substance** of the scheme
3. The **time** at which the scheme was entered into and the **length** of the period during which the scheme was carried out. The question to be addressed is, do the timing and duration of the scheme contribute towards delivering the related tax benefit, or are they related to commercial opportunities or requirements? The fact that a scheme is entered into shortly before the end of a financial year (or the date of a change in the rate of tax) and carried out for a brief period may point to the purpose of obtaining a tax benefit. Similarly, the fact that the timing of the scheme is not related to a commercial opportunity may add weight to such a conclusion.

4. The **result achieved** by the scheme under the income tax law if Part IVA did not apply
5. Any change in the **financial position** of the **relevant taxpayer** that has resulted, will result, or may reasonably be expected to result from the scheme. The absence of any genuine change in a person’s overall financial, legal or economic position is likely to add weight to the dominance of the tax purpose.
6. Any **change in the financial position of any person** who has, or has had, any **connection (whether of a business, family or other nature)** with the relevant taxpayer, being a change, that has resulted, will result, or may reasonably be expected to result, from the scheme
7. Any **other consequences** for the relevant taxpayer, or for any person referred to in matter 6 (above) of the scheme having been entered into or carried out, and
8. The **nature of any connection** (whether of a business family or other nature) between the relevant taxpayer and any other person referred to in matter 6 - For example, a business person giving assets to strangers for less than their value would be subject to enquiry, but a gift to a family member could be seen in a different light.

Answering the purpose question and tax benefit questions are generally the most critical steps in determining whether Part IVA will apply.

The purpose question, requires an objective conclusion to be reached about the purpose of a relevant person, and is determined after considering the eight specified matters above. While applying the purpose test, it is important to understand the relationship between each of the eight matters, and to consider and weigh them together in a practical and common sense way to get at the substance of what is really going on.

⁵⁹ *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* [2011] 192 FCR 325, 348.

⁶⁰ *RCI Pty Ltd v Commissioner of Taxation* [2010] 272 ALR 347, 369.

⁶¹ *Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* [2011] 192 FCR 325, 371-3.

⁶² Section 177F(1) of the ITAA and Tax Office Guidance

⁶³ Section 177B of the ITAA

⁶⁴ Section 177D of the ITAA

Below are some *illustrative examples* that show how the courts have interpreted the “dominant purpose test”:

- A person may enter into a scheme enabling a tax benefit, within the meaning of Part IVA, where that dominant purpose is *consistent with the pursuit of a commercial gain* in the course of carrying on a business. That is, the fact that part of the overall transaction was profit making does not make it artificial and inappropriate to observe that another part of the structure is a scheme for the purposes of Part IVA.
- A purpose will be the dominant purpose where it is the **“ruling, prevailing or most influential purpose.”**⁶⁵
- The time for testing the dominant purpose is the **date the scheme was entered into** and by reference to the law as it then stood.⁶⁶
- In addition to its findings on tax benefit, the Full Federal Court in *RCI Pty Limited v Commissioner of Taxation*⁶⁷ made the following comments about the dominant purpose test. It stated that the only objective indicia suggesting that the taxpayer had a dominant purpose of obtaining a tax benefit was the size of the intercompany dividend in question, which was considerably greater than the dividend paid in the previous year. However, the Court accepted the taxpayer’s explanation of the size of the dividend as being part of a process of repatriation of funds from the US group to Australia; and stated that on its own this indicia was not sufficient to demonstrate a dominant purpose of obtaining a tax benefit. Further, the Full Federal Court determined that there was no commitment by the board to the share transfer at the time of declaring the dividend, indicating that the dividend was not declared for the dominant purpose of obtaining the tax benefit contended by the Commissioner.

It is also possible for the tax payer to obtain private, class or product rulings from the Australian Tax Office (ATO).

Before a Tax Officer applies the GAAR, he is required to refer the matter to the ATO’s tax counsel area for consideration. The Tax Counsel Area comprises of senior tax officers who specialise in Part IVA. If they agree that the GAAR may apply, the matter is referred to the GAAR Panel who has the task of giving independent and objective advice to the relevant Tax Officer on whether to apply the GAAR to the arrangement. The Panel is made up of business and professional people and senior tax officers. The role of the Panel is purely consultative. The tax payer is also given an opportunity to make a representation before the Panel.

3. Approach of the tax authorities

The ATO has prepared a guide to enable tax payers to identify whether there is a risk that Part IVA may apply to any arrangement. The aspects that one needs to see are as follows:

- Is the arrangement (or any part of the arrangement) out of step with ordinary family dealings or the sort of arrangements ordinarily used to achieve the relevant commercial objective?
- Does the arrangement seem more complex than is necessary to achieve the relevant family or commercial objective? Is there a step or a series of steps involved in the arrangement that appear to serve no real purpose other than to gain a tax advantage? For example:
 - transactions which interpose an entity to access a tax benefit
 - intra-group or related party dealings that merely produce a tax result, or
 - arrangements involving a circularity of funds or no real money.
- Does the tax result appear at odds with the commercial or economic result? For example, a tax loss is claimed for what was a profitable commercial venture or transaction.

- Is there little or no risk in circumstances where significant risks would normally be expected? For example:

- use of non-recourse or limited recourse loans which limit the parties’ risk or actual detriment in relation to debts/ investments, or
- arrangements where the taxpayer’s risk is significantly limited because of the existence of, for example, a ‘put’ option (a put option exists when you have the right to make someone else acquire something you have at an agreed price).
- Are the parties to the arrangement operating on non-commercial terms or in a non-arm’s length manner? For example:
 - financial arrangements made on unusual terms, such as interest rates above or below market rates, insufficient security or deferment of repayment of the loan until the end of a lengthy repayment period, or
 - transactions which do not occur at market rates/value.
- Is there a gap between the substance of what is being achieved under the arrangement (or any part of it) and the legal form it takes? For example, arrangements where a series of transactions taken together produce no economic gain or loss, such as where the whole scheme is self-cancelling.

4. Judicial Precedents

In the recent past there have been a number of judgments which have laid to rest a lot of previous uncertainties, as regards several issues pertaining to Part IVA application. The recent cases demonstrate that a taxpayers evidence will more often than not, be the determining factor as to whether Part IVA will apply.

⁶⁵ *Federal Commissioner of Taxation v Spotless Services Limited* [1996] 186 CLR 404, 416.

⁶⁶ *Commissioner of Taxation v Consolidated Press Holdings Ltd* [1999] 91 FCR 524, 552.

⁶⁷ *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104, [165]-[169].

Some significant judicial precedents are as follows:

- **Commissioner of Taxation v Hart**⁶⁸ - the High Court unanimously upheld that a “wealth optimiser” home loan product fell within the ambit of Part IVA. The purpose of the loan was to finance the acquisition of a personal residence and to refinance an investment property held by the taxpayers. The product was purposefully structured so as to direct all the interest repayments to that part of the loan that related to the residence. The result was that interest on that part of the loan relating to the investment property accrued at compounding rates which increased the total amount payable (and therefore the available deductions).

It was discussed that the enquiry to determine the dominant purpose of a transaction will require a comparison between the transaction actually entered into and “what other possibilities existed”. This prediction of events otherwise expected to have occurred is often referred to as the “counterfactual”. It also discussed that such a comparison (or the consideration of the counterfactual) enabled the Court to ascertain whether those alternatives would have enabled the taxpayers to achieve their objectives “more conveniently, or commercially or frugally” and that such a comparison would greatly assist the Court in reaching a conclusion about the taxpayers’ purpose

The High Court considered it critical that an otherwise commercial transaction possessed particular features directed only at securing a tax benefit. The presence of such unique and compelling features, when compared to an alternative means of achieving the same commercial outcome, weighed heavily in the conclusion that the dominant purpose of the scheme was tax driven.

- In contrast to Hart (above) is the recent decision of the Full Federal Court in **News Australia Holdings**⁶⁹ where a favorable tax outcome (a buy-back of shares that had the effect of producing a capital loss of approximately AUD 1.5b) arising in a large commercial transaction (the restructure of the global News Corp group) was found not to be subject to Part IVA. Crucial to this finding was the Court’s acceptance of the taxpayer’s “no tax, no tax risk policy” which meant that any alternate means of achieving the same commercial outcome, but which would have resulted in the group paying tax, would not have been entered into.
- **British American Tobacco Services Ltd**⁷⁰ –this concerned the potential application of Part IVA to the means by which the taxpayer disposed of nine cigarette brands to a competitor, under the compulsion of ACCC requirements, as part of a wider merger being entered into with the Rothmans group. The sale of the brands to a member of the Rothmans Group which then on-sold it to the competitor company enabled the taxpayer and Rothmans to take advantage of accrued capital losses in the Rothmans Group and correspondingly enabled rollover relief in relation to those capital gains made by the taxpayer on the sale of the brands.

In concluding that Part IVA should apply the Court held that there was no commercial or legal reason why the disposition of the brands could not have been effected from a single vendor and accordingly the Court found that when the scheme was compared with the counterfactual, it revealed that the manner in which the scheme was formulated and carried out was, explicable only by taxation consequences. Particularly relevant was the correspondence between the parties that mandated the need to complete the merger prior to entering into any contractually binding agreements for the sale of the relevant brands, which created the framework for claiming rollover relief.

Critical to the Court’s findings were the evidentiary conclusions drawn on how the scheme was crafted when compared to other means available for achieving the same commercial outcome. In seeking leave to appeal to the High Court, the taxpayer contended that despite the tax benefit being the operative reason for why the disposal of the brands was structured in that way (i.e. not via a direct sale), the mere fact that one step in a wider scheme was to obtain a tax benefit should not mean that the dominant purpose of the entire scheme identified by the Commissioner was achieving that benefit. The taxpayer contended the adoption of the “strategy” was to give effect to an overall commercial purpose. In refusing the taxpayer’s application, it was held that “the Full Court applied an uncontroversial interpretation of the legislation to the facts”⁷¹ and accordingly dismissed the special leave application, the effect of which was that Part IVA was found to apply.

- **AXA Asia Pacific Holdings Ltd**⁷² - After applying a forensic approach to conclude upon the prediction of events otherwise expected to have occurred, it was held that the taxpayer’s actions in structuring its disposal of AXA Health through an interposed entity (which resulted in scrip-for-scrip rollover relief becoming available and the indefinite deferral of AUD 122 million in capital gains tax) should not be subject to Part IVA as no tax benefit could be found to exist. The Full Court considered that the taxpayer had duly discharged its onus of proof in demonstrating that the Commissioner’s counterfactuals were “not sufficiently reliable to be regarded as reasonable” The Full Court concluded that the Commissioner’s *alternative postulate* was *contrary to the evidence adduced and not supported by the facts* and therefore the Commissioner’s Part IVA action failed. The Court also noted that given that Part IVA litigation is now focused on “scheme” and the “alternative postulate” identified by the parties, the litigation runs the risk of creating considerable artificiality often divorced from the commercial reality.

68 *Commissioner of Taxation v. Hart* [2004] 219 CLR 216

69 *Commissioner of Taxation v. News Australia Holdings Pty Ltd* [2010] FCAFC 78

70 *British American Tobacco Services Limited v. Commissioner of Taxation* [2010] FCAFC 130

71 *British American Tobacco Services Limited v. Commissioner of Taxation* [2011] HCATrans 94

72 *AXA Asia Pacific Holdings Ltd v. Federal Commissioner of Taxation* [2009] FCA 147

- In the case of *Citigroup Pty Limited*⁷³ it was held that Part IVA should apply to disallow foreign tax credits (FTC) of approximately AUD 23 million claimed by the taxpayer in relation to two Hong Kong bond transactions. The relevant transactions were a bond strip trade involving the subscription of an interest bearing bond and an immediate sale of its interest coupon for a lump sum payment. The taxpayer claimed a FTC for the Hong Kong tax paid on this lump sum received. The Court held that the taxpayer had entered into the transactions for the dominant purpose of obtaining a tax benefit and noted that “absent the foreign tax credits, the transactions did not make sense.”

It should be noted that the above is a high level summary and any view as to the application of Part IVA in a specific case depends upon close attention to the facts and evidence.

5. *Compensating adjustments*

Once the Commissioner has made a determination to cancel a tax benefit under section 177F(1) or 177F(2A) of the ITAA he may make a compensating adjustment under section 177F(3) of the ITAA to the assessable income of the same or another taxpayer if he considers it fair and reasonable to do so. This power is not limited by the limitation period to issue amended assessments in section 170 (referred to below).

It should be noted that in *Australia New Zealand Banking Group Limited v Commissioner of Taxation*⁷⁴ the Court held that it was open for the Commissioner to delay making a compensating adjustment as there was a possible risk to the revenue if a premature determination was made in section 177F(3). As such, it was held that the “matter falls properly to be judged at the conclusion of the objection, review and appeal processes and not earlier”.

6. *Penalties*

The Australian taxation system imposes administrative penalties in relation to certain acts and omissions by a taxpayer. Central to this is the imposition of a base penalty which is a penalty of 25% (lack of reasonable care), 50% (recklessness) or 75% (intentional disregard of a taxation law) of the tax shortfall depending on the taxpayer’s level of care in complying with a taxation law.

Where a taxpayer attempts to reduce its tax-related liabilities or increase its credits through a scheme (such as a scheme to which Part IVA applies) an additional penalty could be imposed up to 70% of the tax benefit the taxpayer would have obtained had the scheme not been disallowed by Part IVA⁷⁵.

7. *Limitation period*

In order to make a determination that a tax benefit be cancelled, the Commissioner will be required to issue an amended assessment to the taxpayer.

The Commissioner generally has the power to issue amended assessments for a limited time after the original notice of assessment is issued to the taxpayer. Broadly this applies as follows:

- For individuals and small business entities the Commissioner has two years to amend an assessment; and
- For all other taxpayers the Commissioner has four years to amend an assessment⁷⁶.

⁷³ *Citigroup Pty Limited v Commissioner of Taxation* [2011] FCAFC 61

⁷⁴ *Australia New Zealand Banking Group Limited v Commissioner of Taxation* [2003] 137 FCR 1

⁷⁵ *Subdivision 284-C of the Taxation Administration Act 1953*

⁷⁶ *Section 170 of the Income Tax Act, Canada*

Canada

1. Overview

Section 245 of the Income tax Act (Act), i.e. the Canadian GAAR⁷⁷, became effective on 13 September, 1988. However, it has been stipulated that transactions that began before 13 September 1988 and that were completed before 1989, would not be subject to the GAAR, nor would transactions entered into before April 13, 1988 where the taxpayer had received a confirmation or opinion in writing with respect to the tax consequences from the tax authorities⁷⁸.

In the words of the Canadian Supreme Court⁷⁹ - *“The Income Tax Act remains an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation. Onto this compendium of detailed stipulations, Parliament has engrafted quite a different sort of provision, the GAAR. This is a broadly drafted provision, intended to negate arrangements that would be permissible under a literal interpretation of other provisions of the Income Tax Act, on the basis that they amount to abusive tax avoidance”*. The Court has also observed that the GAAR was enacted as a provision of last resort in order to address abusive transactions; it was not intended to introduce uncertainty in tax planning.

The Explanatory Notes⁸⁰ listed out the purpose of the GAAR as - *“New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.”*

2. Anti avoidance provisions

The application of the GAAR involves three steps⁸¹:

- The first step is to determine whether there is a “tax benefit” arising from a “transaction”
- The second step is to determine whether the transaction is an avoidance transaction in the sense of not being “arranged primarily for bona fide purposes other than to obtain the tax benefit”.
- The third step is to determine whether the avoidance transaction is abusive

All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit.

These key terms have been defined in the Act as follows:

- **‘Tax benefit’** means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty⁸².
- **‘Transaction’** includes an arrangement or event.⁸³ In case of reference to a series of transactions or events, the series is deemed to include any related transactions or events completed in contemplation of the series⁸⁴.
- **General anti-avoidance provision** where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that would result from that transaction or from a series of transactions that includes that transaction.⁸⁵
- **Avoidance transaction** - means any transaction⁸⁶

- a. that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or
- b. that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

GAAR does not apply to an avoidance transaction if it may reasonably be considered that the transaction would not result in a misuse of the provisions of the Act, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under the Act or in determining any amount that is relevant for the purposes of that computation or an abuse having regard to the those provisions read as a whole⁸⁷.

Determining whether there has been misuse or abuse is a two-stage analytical process. The first stage involves identifying the relevant policy of the provisions or the Act as a whole. The second is the assessment of the facts to determine whether the avoidance transaction constituted a misuse or abuse having regard to the identified policy.⁸⁸

The tax consequences in case the transaction is hit by the GAAR are wide ranging and could be:

- a. any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,

77 Enacted by Parliament as a part of Bill C-139, Effective date being the date on which Bill C-139 received the Royal Assent.

78 IC 88-2 – General Anti-avoidance Rule: Section 245 of the Income Tax Act

79 The Queen v. Canada Trustco Mortgage Company 2005 SCC 54 para 13 and 14

80 The Explanatory Notes to Legislation Relating to Income Tax issued by the Honourable Michael H. Wilson, Minister of Finance (June 1988) (“Explanatory Notes”) are an aid to interpretation

81 The Queen v. Canada Trustco Mortgage Company 2005 SCC 54 para 18

82 Section 245(1) of the Income Tax Act, Canada

83 Section 245(1) of the Income Tax Act, Canada

84 Section 248(10) of the Income Tax Act, Canada

85 Section 245(2) of the Income Tax Act, Canada

86 Section 245 (3) of the Income Tax Act, Canada

87 Section 245(4) of the Income Tax Act, Canada

88 The Queen v. Canada Trustco Mortgage Company 2005 SCC 54

- b. any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person,
- c. the nature of any payment or other amount may be recharacterised, and
- d. the tax effects that would otherwise result from the application of other provisions of the Act may be ignored.

3. Approach of the tax authorities

The GAAR Committee – The CRA has a committee that reviews potential GAAR assessments. This GAAR committee is made up of representatives from various divisions of the CRA, with participation as well from the Department of Finance and the Department of Justice. The committee advises on whether it is appropriate to apply the GAAR in particular fact situations and whether the application is consistent with how GAAR has been applied in other cases. Although the committee has no statutory mandate and there is no legal requirement that CRA auditors adopt its advice, it is understood that they almost always do.

The CRA has consistently taken the position that the GAAR can be applied to deny a treaty benefit to a non-resident of Canada who “enters into a series of transactions designed primarily to secure an exemption or reduction from Canadian tax under an income tax convention that Canada has with another country”⁸⁹.

On 21 October, 1988, the CRA released Information Circular 88-2 (the Circular)⁹⁰ to provide guidance with respect to the application of the GAAR. A Supplement⁹¹ to the Circular was issued in 1990. The Circular states:

- An avoidance transaction is a single transaction carried out primarily to obtain a tax benefit. Where a transaction, which is primarily tax – motivated, forms part of a series of transactions that is carried out primarily for non-tax purpose, the single transaction will nevertheless be an avoidance transaction. The fact that the series of transactions has bona fide a non-tax purposes does not preclude a tax-motivated transaction that forms

part of the series from being an avoidance transaction.

- The purposes of a transaction are determined not only from the taxpayer’s statement of intention but also from all the circumstances of the transaction or transactions. If it can be inferred from all the circumstances that the primary or principal purpose in undertaking the transaction is other than to obtain a tax benefit, then the transaction is not an avoidance transaction.
- A transaction will not be an avoidance transaction if the taxpayer establishes that it is undertaken primarily for a bonafide business, investment or family purpose.
- The CRA will issue advance rulings with respect to the application of the GAAR to proposed transactions and will publish summaries of the facts and rulings in those cases that will provide further guidance.
- In order to ensure that the rule is applied in a consistent manner, proposed assessments involving the rule will be reviewed by Revenue Canada, Taxation Head Office.
- Transactions that rely on specific provisions, whether incentive provisions or otherwise, for their tax consequences, or on general rules of the Act can be negated if these consequences are so inconsistent with the general scheme of the Act that they cannot have been within the contemplation of Parliament. On the other hand, a transaction that is consistent with the object and spirit of provisions of the Act is not to be affected.

The Circular also lists out certain examples to illustrate the approach the tax authorities will take in such cases:

- Examples of some situations where the GAAR would not apply:
 - An individual transfers his business to a corporation primarily to obtain benefit of small business deduction (provided in section 125 of the Income tax Act)

- A taxable Canadian corporation, which is profitable, has a wholly-owned taxable Canadian corporation that is sustaining losses and needs additional capital to carry on its business. The subsidiary could borrow the monies from its bank but the subsidiary could not obtain any tax saving in the current year by deducting the interest expense. Therefore, the parent corporation borrows the money from its bank and subscribes for additional common shares of the subsidiary and reduces its net income by deducting the interest expense. The subsidiary uses the money to gain or produce income from its business.

- Examples of some situations where the GAAR would apply:

- A corporation issues stock dividend which is then bought back by a related company. The payment and repurchase of the stock dividend shares being part of an arrangement to avoid the shareholder tax required to be paid on dividends from the corporation.
- The acquisition of preference shares as part of an arrangement designed to avoid tax that would have been required to be paid on salary.

4. Judicial precedents

Some of the significant judicial precedents are discussed below:

- **The Queen v. Canada Trustco Mortgage Company**⁹² - The issue was whether the GAAR applied to deny the capital cost allowance (CCA) claimed in respect of a sale-leaseback transaction. The taxpayer purchased trailers and leased them back to the original vendor through a series of transactions. These transactions were structured in such a manner as to allow the taxpayer to substantially minimise its financial risk. This arrangement allowed the taxpayer to defer paying taxes on the amount of profits reduced by the CCA deductions which would be subject to recapture into income when the trailers were disposed of at a future date and presumably in excess of the amount claimed as CCA.

⁸⁹ Revenue Canada Round Table: Canada-US and International Issues, in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference [Toronto: Canadian Tax Foundation, 1994], 22:1-32, question 11, at 22:9. Also in the *CRA Income Tax Technical News No. 30 May 21, 2004*

⁹⁰ IC 88-2 – General Anti-avoidance Rule: Section 245 of the Income Tax Act

⁹¹ Information Circular 88-2S1, “General Anti-avoidance Rule – Supplement 1”, 13 July, 1990

⁹² *The Queen v. Canada Trustco Mortgage Company* 2005 SCC 54

The Court held that the transaction at issue was not so dissimilar from an ordinary sale-leaseback as to take it outside the object, spirit or purpose of the relevant CCA provisions of the Act. The purpose of the CCA provisions of the Act, as applied to sale-leaseback transactions, was, as found by the Tax Court judge, to permit the deduction of a CCA based on the cost of the assets acquired. This purpose emerges clearly from the scheme of the Act's CCA provisions as a whole. The Minister's suggestion that the usual result of the CCA provisions of the Act should be overridden by section 245(4) in the absence of real financial risk or "economic cost" in the transaction must be rejected. This suggestion distorts the purpose of the CCA provisions by reducing them to apply only when sums of money are at economic risk. The applicable CCA provisions of the Act do not refer to economic risk. They refer only to "cost" and in view of the text and context of the CCA provisions, they use "cost" in the well-established sense of the amount paid to acquire the assets. Where Parliament has wanted to introduce economic risk into the meaning of cost related to CCA provisions, it has done so expressly.

The Court laid down the following broad principles:

- Three requirements must be established to permit application of the GAAR:
 - i. there must be a tax benefit resulting from a transaction or part of a series of transactions.
 - ii. the transaction must be an avoidance transaction in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a bona fide purpose other than to obtain a tax benefit; and
 - iii. there must be abusive tax avoidance in the sense that it cannot be reasonably concluded that allowing a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

- The burden is on the taxpayer to refute (i) and (ii), and on the minister to establish (iii).
- If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.
- The Courts should proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the act that confer the tax benefit, read in the context of the whole Act.
- Whether the transactions were tax motivated may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under subsection 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance.
- Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.
- Where the tax court judge has proceeded on a proper construction of the provisions of the act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.

- **Kaulius et al v. The Queen**⁹³ - The primary purpose of each transaction in the series was to transfer Standard Trust Co. losses into Partnership A so that Partnership A could serve as a vehicle to sell the losses to arm's length taxpayers. Ultimately, the appellants, who dealt with Standard Trust Co at arm's length, purchased the tax losses through the use of Partnership B. The appellants deducted those losses against other income and some also computed non-capital losses to be carried forward or back. In return they provided funds which found their way back to Standard Trust Co, which thus recovered a portion of its loss on the non-performing mortgages. The appellants relied on a combination of section 18(13)⁹⁴ and the partnership provisions of the Income Tax Act to claim the losses. This was essentially a series of transactions aimed at transferring unrealised losses from one arm's length taxpayer to another.

The Supreme Court held that to allow the taxpayers to claim the losses in this case would defeat the purposes of Section 18(13) and the partnership provisions. Interpreted textually, contextually and purposively, Section 18(13) and Section 96 do not permit arm's-length parties to purchase the tax losses preserved by sub-section 18(13) and claim them as their own. The purpose of subsection 18(13) is to transfer a loss to a non arm's-length party in order to prevent a taxpayer who carries on a business of lending money from realising a superficial loss. Parliament could not have intended that the combined effect of the partnership rules and subsection 18(13) would preserve and transfer a loss to be realised by a taxpayer who deals at arm's length with the transferor. The use of these provisions to preserve and sell unrealised losses to an arm's-length party results in abusive tax avoidance under Section 245(4).

⁹³ *Kaulius et al v. The Queen* 2005 SCC 55

⁹⁴ S.18(13) deemed the cost of the mortgages to be the same to Partnership A as their cost to STC.

China

1. Overview

Provisions relating to the GAAR were introduced in the Chinese Corporate Income Tax law (CIT Law), which became effective on 1 January 2008. The Chinese tax authorities have also issued detailed administrative and procedural guidelines to facilitate the implementation of the GAAR. Further, a GAAR article allowing China to invoke its GAAR provisions under its domestic tax laws has been added in a few recent treaties, e.g. the new Sino-UK tax treaty which concluded on 27 June 2011. Article 23 of the said treaty stipulates that:

Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement.

2. Anti-avoidance Provisions

- **Article 47** of the CIT Law dealing with the GAAR reads as follows (unofficial English translation):
“Where an enterprise enters into other arrangements without reasonable commercial purpose and this results in a reduction of taxable gross income or taxable income, the tax authorities shall have the authority to make adjustment using appropriate methods”
- The term ‘without reasonable commercial purpose’ is defined in **Article 120** of the Implementation Regulations of the CIT law, as: “where the main purpose is the reduction, exemption or deferral of tax payments”.

- The term ‘main purpose’ is however not defined in the CIT law.
Further, according to **Article 123**, where an enterprise implements an arrangement without reasonable commercial purpose, the tax authorities shall have the right to make tax adjustments within 10 years starting from the tax year during which the transaction takes place.
- The China State Administration of Taxation (SAT) has also released **Circular 698**⁹⁵ to scrutinise indirect transfers where non-China Tax Resident Enterprises (Non-TREs) indirectly transfer Chinese companies’ equity by disposing the shares in offshore Special Purpose Vehicles (SPVs). Circular 698 imposes a reporting obligation on Non-TRE investors who transferred the shares in offshore SPVs in some specified jurisdictions which in turn hold Chinese companies’ equity⁹⁶. Following the introduction of the reporting obligation, Circular 698 further stipulates how to apply GAAR provisions based on the assessment of the documents and information reported by the Non-TRE investors. However, reporting of indirect transfer is not a prerequisite for the application of GAAR.

According to Circular 698:

Where the Non-TRE investor (Effective Controlling Party) through the use of abusive arrangement, such as organisational structure, which does not have a reasonable commercial purpose to indirectly transfer the equity in a Chinese TRE, for the purpose of avoiding income tax liabilities, the in-charge tax authority can, after reporting to the higher level authorities and examined by the SAT, re-characterise the equity transfer based on its economic substance and disregard the existence of the overseas intermediary holding company under such tax-avoidance arrangement⁹⁷.

- **Circular 601**⁹⁸ aims at limiting the abuse of double tax treaties for treaty shopping purposes. It provides rules for determining the “beneficial owner” for the purpose of claiming tax treaty benefits in respect of dividends, interest, and royalties. Agents and conduit companies (i.e., companies established to avoid or reduce tax or shift profits) are not beneficial owners for purposes of Circular 601.
- **Circular 124**⁹⁹ gives detailed administrative rules for treaty residents to claim treaty benefits. The rules provide that non-residents will not be automatically granted the benefits under DTAs, and will be required to comply with administrative rules to receive them. Income derived by non-residents is divided into two categories and is subject to different procedures for claiming treaty benefits.
For passive incomes, i.e. dividends, interest, royalties, and capital gains, non-residents must adhere to an ‘application-approval’ procedure. For active income, such as business income of PEs, independent personal services, and dependent personal services, non-residents must satisfy the ‘record-filing’ procedure.

95 Tax circular Guoshuihan [2009] No. 698 – “Notice on strengthening the administration on collection of Enterprise Income Tax on income from equity transfers by non-resident enterprises”, 10 December 2009

96 Article 5 of Circular 698 – “Where the Non-TRE investor (Effective Controlling Party) indirectly transfers the equity of a Chinese TRE, if the overseas intermediary holding company being transferred by the Non-TRE investor is established in a country/ region where the effective tax rate is less than 12.5% or which does not tax the overseas income of its resident, the Non-TRE investor shall submit the following documents to the tax authority in charge of the Chinese TRE within 30 days after the equity transfer agreement is concluded:

(1) Equity transfer contract/agreement;

(2) Documents illustrating the relationship between the Non-TRE investor and the overseas intermediary holding company being transferred in respect of financing, operation, sales and purchase, etc.;

(3) Documents illustrating the operation, personnel, finance and properties of the overseas intermediary holding company being transferred;

(4) Documents illustrating the relationship between the overseas intermediary holding company being transferred and the Chinese TRE in respect of financing, operation, sales and purchase, etc.;

(5) Documents illustrating the reasonable commercial purpose of the Non-TRE investor in setting up the overseas intermediary holding company being transferred; and

(6) Other relevant documents required by the tax authority.”

97 Article 6 of Circular 698

98 Tax circular Guoshuihan [2009] No. 601 – “Notice on how to understand and confirm ‘beneficial owner’ under tax treaties”

99 Circular Guoshuiha [2009] No.124 - “Administrative measures on claiming tax treaty treatment by non-residents”, effective date of October 1, 2009

3. Approach of the tax authorities

- The SAT has also issued a Circular on the “Implementation Measures of Special Tax Adjustments (Trial)”, (Circular 2)¹⁰⁰ in January 2009 and it contains a chapter elaborating on the administration of GAAR. The salient features¹⁰¹ are produced below:
- Tax authorities may, in accordance with Article 47 of the CIT Law and Article 120 of the Implementation Regulations of the CIT law, initiate a general anti-avoidance investigation on enterprises with tax avoidance arrangements listed as follows¹⁰²:
 - Abuse of preferential tax treatments;
 - Abuse of tax treaties;
 - Abuse of organisational structures;
 - Use of tax havens for tax avoidance purposes; and
 - Other arrangements without reasonable commercial purposes.
- Tax authorities shall evaluate whether an enterprise is involved in a tax avoidance arrangement based on the principle of substance over form, and consider the following factors in a comprehensive review of the arrangement:
 - Form and substance of the arrangement;
 - Time of establishment and the term of the arrangement;
 - How the arrangement is implemented;
 - Relationship between each step of the arrangement or relationship between each component of the arrangement;
 - Changes in the financial position of all parties involved in the arrangement; and
 - Tax results of the arrangement.¹⁰³
- Tax authorities shall re-characterise the enterprise’s tax avoidance arrangement according to its economic substance, and shall eliminate the tax benefits obtained by the enterprise from such arrangement. If a corporation does not have economic substance, especially if it is established in a tax haven for tax avoidance purposes, its existence can be disregarded for taxation purposes.¹⁰⁴
- When tax authorities initiate a general anti-avoidance investigation, they shall issue a “Tax Investigation Notice” to the enterprise in accordance with the relevant provisions in the Tax Collection Law and Tax Collection Regulations. The enterprise shall, within 60 days after receiving the notice, provide information to prove that the arrangement has reasonable commercial purposes. If the enterprise fails to provide the information within the prescribed time frame, or the information provided cannot prove that the arrangement has reasonable commercial purposes, tax authorities may make tax adjustments based on the information already obtained, and issue a “Special Tax Investigation Adjustment Notice” to the enterprise.¹⁰⁵
- All general anti-avoidance investigations and adjustments must be submitted step-by step upward to the SAT for approval.¹⁰⁶

¹⁰⁰ Guo Shui Fa [2009] No. 2

¹⁰¹ Chapter 10 - Administration of General Anti-avoidance (Unofficial English Translation)

¹⁰² Article 92 of Circular 2

¹⁰³ Article 93 of Circular 2

¹⁰⁴ Article 94 of Circular 2

¹⁰⁵ Article 95 of Circular 2

¹⁰⁶ Article 97 of Circular 2

Germany

1. Overview

Section 42 of the German Tax Code (GTC) provides for the GAAR in German tax law. The current version of the section 42 is applicable from 1 January 2008. This provision has three important features, namely:

- Inappropriate tax planning constitutes abuse
- The presumption of abuse can be rebutted by the tax payer by demonstrating sound business reasons of the particular structure
- The GAAR is superseded if a special anti-abuse rule applies

2. Anti avoidance provisions

Section 42 of the GTC¹⁰⁷ dealing with the abuse of tax planning schemes provides as follows:

(1) It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. Where the element of an individual tax laws provision to prevent circumventions of tax has been fulfilled, the legal consequences shall be determined pursuant to that provision. Where this is not the case, the tax claim shall in the event of an abuse within the meaning of subsection (2) below arise in the same manner as it arises through the use of legal options appropriate to the economic transactions concerned.

(2) An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. This shall not apply where the taxpayer provides evidence of nontax reasons for the selected option which are relevant when viewed from an overall perspective.

Thus the term abuse has now been defined in the GTC which provides that an abuse occurs only if the taxpayer chooses an ‘inappropriate legal option’. However, the statute does not define what the term ‘inappropriate’ denotes.

According to the German Federal Tax Court (GT Court) the word ‘inappropriate’ describes any legal structure that two unrelated and reasonable parties would not have chosen to achieve a specific business goal. In essence, inappropriate structures are, in the view of the GT Court ‘complex, complicated, and artificial.’¹⁰⁸

3. Approach of the tax authorities

The tax authorities are obliged to prove the inappropriateness of a legal structure and the generation of an unintended tax benefit. However, the taxpayer has a right to rebut and demonstrate that the overall structure is based on relevant nontax reasons. These non tax reasons could be economic or personal. ‘Relevant’ describes reasons and facts that must be considered in light of all circumstances.¹⁰⁹

If it is not possible to provide evidence for the existence of non tax reasons, tax becomes due as it would be due on a legal structure.

¹⁰⁷ Translation provided by the Language Service of the Federal Ministry of Finance

¹⁰⁸ Germany’s New GAAR featured in *Tax Notes International Volume 49, No. 2 14 January, 2008, p.151*

¹⁰⁹ Germany’s New GAAR featured in *Tax Notes International Volume 49, No. 2 14 January, 2008, p.152*

South Africa

1. Overview

The current version of the South African GAAR, is codified under sections 80A to 80L of the South Africa Income Tax Act, No. 58 of 1962 (the SA Act). It may be noted that the proposed Indian GAAR is heavily influenced by the provisions of the South African GAAR.

Before the introduction of the GAAR in the present form, the South African Government invited written comments on a detailed discussion paper released by the SARS, which laid down the rationale behind the revision in the earlier GAAR provisions to bring them to their current form, international practices in this regard and the purpose it intends to achieve.

Following the submissions and discussions, the final GAAR proposals were incorporated into the SA Act by way of the Revenue Laws Amendment Act, No. 20 of 2006 which was assented to on 3 February, 2007 and made applicable to arrangements (including any step or part) entered into on or after 2 November, 2006.

To date these provisions have not been applied much in practice as the SARS tends firstly to apply the more specific anti avoidance measures contained in the SA Act.

2. Anti avoidance provisions

The key provisions of the South African GAAR are as follows:

- Application of GAAR provisions require fulfillment of four requirements, namely¹¹⁰:
 - The existence of an arrangement
 - The existence of an tax benefit (that is, arrangement resulting in a tax benefit)
 - The sole or main purpose of the avoidance arrangement is to obtain a tax benefit
 - The avoidance arrangement is characterised by the presence of any one or more of the tainted elements for arrangements, which renders it an impermissible avoidance arrangement.

- **Arrangement**¹¹¹ means any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.
- **Tax benefit** includes any avoidance, postponement or reduction of any liability for tax¹¹².
- **'Tax'** is defined to include any tax, levy or duty imposed by the SA Act or any other Act administered by the Commissioner¹¹³.
- **Tainted elements** - Once it is established that an arrangement is an avoidance arrangement, as defined, the next step is to determine whether such an avoidance arrangement is an impermissible avoidance arrangement within the meaning of the GAAR. This will be the case if the sole or the main purpose and the requirements of any one or more of the tainted element tests are met viz.,
 - It was entered into or carried out by means or in a manner, which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit.
 - It lacks commercial substance, in whole or in part
 - It has created rights and obligations that would not normally be created between persons dealing at arm's length.
 - It would result directly or indirectly in the misuse of the abuse of the provisions of the SA Act (including the provisions of the GAAR)
- An avoidance arrangement **lacks commercial substance**¹¹⁴ if it would result in a significant tax benefit for a party (but for the GAAR provisions) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the GAAR provisions. Indicative tests showing a lack of

commercial substance include but are not limited to—

- the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
- the inclusion or presence of
 - round trip financing; or
 - an accommodating or tax indifferent party; or
 - elements that have the effect of offsetting or cancelling each other.
- **Onus of proof** - Although the onus to prove that tax avoidance was not the sole or main purpose is placed on the taxpayer, the onus is on SARS to establish the presence of at least one tainted element in order to apply the GAAR.
- **Presumption of Purpose** - An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless the person obtaining the tax benefit proves that obtaining the tax benefit was not the sole or main purpose of the avoidance arrangement¹¹⁵. The onus of rebutting the presumption of purpose test therefore falls on the taxpayer obtaining the benefit.

The purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole¹¹⁶. The underlying parts of the transaction in addition to the transaction as a whole therefore need to be considered
- **Application to steps or parts of an arrangement** - The Commissioner may apply the provisions of this Part to steps in or parts of an arrangement¹¹⁷.

¹¹⁰ Section 80A of the SA Act

¹¹¹ Section 80L of the SA Act

¹¹² Section 80L of the SA Act

¹¹³ Section 80L of the SA Act

¹¹⁴ Section 80C of the SA Act

¹¹⁵ Section 80G of the SA Act

¹¹⁶ Section 80G of the SA Act

¹¹⁷ Section 80H of the SA Act

- **Administration of the GAAR** - Once an arrangement is considered to constitute an impermissible avoidance arrangement, various remedies are available to the Commissioner. These remedies, contained in section 80B, provide that the tax consequences under the SA Act may be determined by –

- disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
- disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;
- deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
- reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
- re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
- treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

- The Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement¹¹⁸.
- The Commissioner must, before determining any liability of a party for tax under these provisions, give the party notice that he believes, at that stage, that the GAAR applies to an impermissible avoidance arrangement and also set out the reasons why he believes the GAAR applies to a particular avoidance arrangement. This provision introduces a statutory safe guard against arbitrary application of the GAAR

provisions. The tax payer is given an opportunity to give reasons before the assessment is raised.

- GAAR provisions may be applied in the alternative for or in addition to any other basis for raising an assessment¹¹⁹.

3. Approach of the tax authorities

The SARS Draft Guide to GAAR¹²⁰ (the guide) provides guidance on SARS's interpretation and application of the GAAR. The Guide indicates that the SARS now clearly differentiates between legitimate tax planning at one end of the scale and tax evasion at the other with impermissible tax avoidance, which is the target of the GAAR, as the unacceptable category in-between.

Some key issues covered by the Guide are as follows:

- The provisions of the GAAR apply to any arrangement (or any steps therein or parts thereof) entered into on or after 2 November 2006. Where a composite arrangement is entered into before 2 November 2006, but a step or part thereof is entered into or carried out subsequent to 2 November 2006, such step or part may be subject to scrutiny in terms of the GAAR, and the remedy provisions may apply.
- These remedies provided under the GAAR provisions allow for the correct amount to be determined in terms of the SA Act. The GAAR is not a charging section as such.
- An avoidance arrangement entered into or carried out in the context of business is an impermissible avoidance arrangement, if its sole or main purpose was to obtain a tax benefit and meets any one or more of the following four tests:
 - **The business purpose test**- Applying the business purpose test requires that a determination is made of whether the arrangement was entered into by means or in a manner that would not normally be employed for bonafide business purposes

- **The commercial substance test** which consists of a general test and a non-exhaustive list of indicative tests, any one or more of which must be satisfied.
- **Abnormal rights and obligations test** - The test whether the arrangement has created rights or obligations that would not normally be created between persons dealing at arm's length, is a factual inquiry, considered against only the hypothetical normal transaction.
- **Misuse or abuse test** - new concept to the anti-avoidance measures and since it has not as such been judicially considered, it must be seen in the context of existing South African legal principles. Guidance on its interpretation may also be sought in other jurisdictions.
- The Guide reiterates the OECD approach that provisions of tax treaties do not generally conflict with the domestic anti-abuse rules:
 - States do not have to grant the benefits of a tax treaty where arrangements have been entered into that constitute an abuse of the provisions of the treaty.
 - Substance-over-form, economic substance and general anti-abuse rules forming part of the underlying domestic rules for determining which facts give rise to a tax liability are not affected by tax treaties. Thus, as a rule, there will be no conflict between domestic anti-abuse rules and provisions of a tax treaty and the GAAR will be applied in the same manner for purely domestic arrangements and arrangements involving an offshore component.
 - Controlled foreign companies legislation, which results in a state taxing its residents on income attributable to their participation in certain foreign entities, is not considered contrary to the provisions of tax treaties.

118 Section 80B(2) of the SA Act
 119 Section 80L of the SA Act
 120 Source: www.sars.gov.za

United Kingdom

1. Overview

The UK does not have a legislative GAAR, however it follows a “judges to decide approach” to the interpretation of tax laws. So there are a plethora of judgments, spanning over decades, which give significant guidance to tax payers and tax authorities. In addition, there are many Targeted Anti-avoidance Rules (TAAR) or specific pieces of tax legislation designed to counteract perceived unacceptable planning. Whilst this combination of legislative law, judges made interpretation and public guidance often make it relatively clear as to when and how the tax authorities would apply anti-avoidance measures, there will always be uncertainties and interpretational issues in most complex situations.

In December 2010, a study group¹²¹ was constituted to analyse the need of legislative GAAR in the UK. In its recently submitted Report it has been pointed out that a broad spectrum GAAR would not be beneficial for the UK tax system as it would carry “a real risk of undermining the ability of business to carry out sensible and responsible tax planning”. However, the Report says that introducing a narrowly focussed GAAR which does not apply to reasonable tax planning, and instead targets abusive arrangements, would be beneficial.

2. Approach of the tax authorities

A disclosure regime¹²², the Disclosure of Tax Avoidance Schemes (DOTAS) was introduced with effect from 1 August 2004 which today covers Income Tax, Corporation Tax and Capital Gains Tax. A tax arrangement must be disclosed:

- a. when it will, or might be expected to, enable any person to obtain a tax advantage
- b. that tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement
- c. it is a tax arrangement that falls within any description (‘hallmarks’) prescribed in the relevant regulations

In most situations, a disclosure is required to be made by the scheme promoter within the specified time. However, in some cases the obligation has been cast on the scheme user. Upon disclosure, HMRC issues an eight-digit scheme reference number. By law the promoter must provide this number to each client that uses the scheme, who in turn must include the number on his or her return. A number of specific anti-avoidance provisions have been introduced in response to such disclosures.

3. Judicial precedents

- The House of Lords, in its decision in the case of *Barclays Mercantile Business Finance Limited v. Mawson*¹²³, sought to restrict the extent to which the Inland Revenue may strike down tax efficient arrangements by reiterating the importance of examining the relevant statutory provision. In essence, this decision gives guidance that the fact that a transaction is a circular or pre-ordained transaction with no commerciality would not of itself be a relevant consideration, if it does not, and did not, affect the necessary elements of the relevant tax statute in question.

Barclays Mercantile Business Finance Limited (BMBF) was a member of the Barclays group which carried on the trade of finance leasing or providing “asset based finance”. BMBF borrowed money from Barclays Bank and then purchased a pipeline from BGE, an Irish statutory corporation, for the supply, transmission and distribution of natural gas in the Republic of Ireland, for GBP 91 million. Following the purchase, BMBF granted a lease back to BGE. The purchase money of Pounds Sterling (GBP) 91 million eventually went back to Barclays Bank through various transactions. The effect was that BGE never held the purchase money of GBP 91 million, but BMBF was entitled to capital allowances under section 24(1) of the Capital Allowances Act 1990. The Inland Revenue challenged the entitlement of BMBF to capital allowances. The Revenue alleged that the payment by BMBF to BGE achieved no commercial purpose, arguing that because commercially driven finance leasing is designed to provide working capital to the lessee, and in this case, the

¹²¹ Source: www.hm-treasury.gov.uk/tax_avoidance_gaar.htm

¹²² Source: www.hmrc.gov.uk/aiu/summary-disclosure-rules.htm

¹²³ *Barclays Mercantile Business Finance Limited v. Mawson* [2004] UKHL 51

lessee, BGE, could not get its hands on the purchase money, by application of the ‘Ramsay’ principle, BMBF did not incur an expenditure of GBP 91 million in the provision of a pipeline for the purpose of its finance leasing trade.

The House of Lords examined, using a purposive construction, what the statute actually requires. At the end, their Lordships held that section 24(1) of the Act is concerned entirely with the acts and purposes of the lessor, i.e. BMBF, and BMBF satisfied all the requirements of section 24(1) of the Act, and accordingly, BMBF should be and is entitled to capital allowances. What the lessee (i.e. BGE) does is “no concern of the lessor”. Whatever arrangements BGE chose to make, even ones involving a circular flow of money or forming part of a pre-ordained transaction, the same were “no concern of the lessor”, because none of the transactions of BGE were necessary elements in creating the entitlement of BMBF to capital allowances under section 24(1) of the Capital Allowances Act. In other words, if a transaction does not affect the necessary elements of a tax statute, be it circular or pre-ordained, it should not be considered a relevant factor in the determination of any tax entitlement under the tax statute.

The significance of this case is that it marks an attempt by the House of Lords (now the Supreme Court) to draw to an end a long series of related cases stretching back to Ramsey and earlier. In essence, the House of Lords laid down a set of principles for interpreting law which can be summarised as:

- Identify the facts of the transaction, and determine which law may apply
- Where the words of the law are clear and certain, they are applied to the transaction
- Only where the words are uncertain, can the Courts look to the underlying purpose of the law.

- **HMRC v Tower MCashback LLP1 and Another**¹²⁴. The case concerned a scheme to raise funds by selling rights to a software package, via software licence agreements (SLAs), to four Limited Liability Partnerships (LLPs). LLP 2 (which was taken as representative of all four LLPs) entered an SLA under which it was to pay GBP 27.5m for a licence and it was entitled to 2.5 percent of the fees received from exploitation of the software. LLP2 obtained the funds required to pay the consideration under the SLA from investors who became investor members of LLP2. They contributed 25 percent from their own funds and obtained the remaining 75 percent as interest free non-recourse loans from an SPV. The financing structure was complex but effectively the investors were not expected to repay these loans. LLP2 claimed GBP 27.5m first year capital allowances for the 2004/05 tax year with the investor members taking the benefit of these allowances if the claim was successful.

The Court concluded that the money that the investor members had borrowed was not real expenditure incurred for the real purpose of acquiring software rights for a significant part of the money did not go to the seller (MCashback) as payment for the rights. Instead, the funds were returned in a loop, bypassing MCashback, to the lender in a pre-ordained manner so as to enable the partnerships to engage in a tax avoidance scheme.

This judgement is entirely consistent with BMBF and Ramsey which together should be considered the leading cases on statutory interpretation of UK tax law.

124 HMRC v. Tower MCashback LLP1 and Another [2011] UKSC 19

United States of America

1. Overview

Until recently the US did not have a general statutory anti-avoidance rule and mainly relied on specific domestic anti abuse provisions and judicial decisions to target tax avoidance schemes. In addition, most of the US treaties have detailed LOB clauses, which define which residents are the qualifying residents, eligible to avail the treaty benefits. The government had for the most part successfully attacked tax products or tax-motivated strategies that were in vogue in the late 1990s and in the 2000s. In an effort to provide uniformity to the tax law, Congress recently enacted section 7701(o) codifying the economic substance doctrine through section 1409(a) of the Health Care and Education Reconciliation Act of 2010(HCERA).

2. Anti avoidance provisions

These provisions apply to transactions entered into after 30 March, 2010. The economic substance doctrine has been defined as the common law doctrine under which certain tax benefits are not allowable if the transaction does not have economic substance or lacks a business purpose. It stipulates that determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if the legislation had never been enacted. It is further provided that in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if:

- the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Further, there are provisions enabling levy of penalty of 20% (40% in certain cases).

The US has a number of overlapping judicial anti-avoidance doctrines¹²⁵ that may be used by the Internal Revenue Service (IRS) to challenge a transaction and deny benefits to tax shelters.

These being:

- **Economic substance doctrine** – To be respected a transaction must have economic substance separate and distinct from economic benefit achieved solely by tax reduction.
- **Sham transaction doctrine** - Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur.¹²⁶
- **Business purpose test** – whether the taxpayer was motivated by no business purpose other than obtaining a tax benefit. This is often used with the economic substance doctrine.
- **Substance over form doctrine** - the concept is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken.
- **Step transaction doctrine** - treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.¹²⁷

In addition to these judicially developed anti-abuse doctrines, the US has several SAARs such as the thin capitalisation rules, transfer pricing and use of the arm's length standard, anti conduit rules, branch profits taxes, hybrid entity rules, foreign tax credit rules and CFC provisions.

3. Approach of the tax authorities

In September 2010, the Large Business and International Division of the IRS issued a directive¹²⁸ (Guidance) to ensure consistent application of the economic substance doctrine. It said that any proposal to impose the doctrine, and also apply the

penalty, at the examination level must be reviewed and approved by the appropriate director of field operations. According to the guidance an examiner should evaluate whether the circumstances in the transaction in question are those under which application of the economic substance doctrine may be appropriate. Following that, if an examiner determines that the application of the doctrine may be appropriate, the guidance provides a series of inquiries an examiner must make before seeking approval for the ultimate application of the doctrine in the examination.

An examiner is required to notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins an analysis. The Guidance contains listing of parameters that could lead to the application of the economic substance doctrine, such as:

- The transaction is highly structured or includes unnecessary steps
- It is not at arm's length with related parties
- Creates no meaningful economic change on a pre-tax present value basis
- Generates a deduction that is not matched by an equivalent economic loss or expense
- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction
- The transaction involves a tax-indifferent counterparty that recognises substantial income
- Transaction has no credible business purpose apart from federal tax benefits
- Transaction has no meaningful potential for profit apart from tax benefits.

¹²⁵ www.irs.gov/pub/irs-utl/ii.b._judicial_doctrines_ii.pdf

¹²⁶ For example, where a taxpayer purported to buy treasury notes for a small down payment and a financing secured by the treasury notes in order to generate favourable tax benefits, but neither the purchase nor the loan actually occurred, the court applied the sham transaction doctrine to deny the tax benefits

¹²⁷ Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987)

¹²⁸ LB&I Directive :Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties dated 15 July, 2011

If it is subsequently believed that it is appropriate to approve an examiner's request to apply the economic substance doctrine, the taxpayer has to be provided an opportunity to explain their position, either in writing or in person, addressing whether the doctrine should be applied to a particular transaction.

Under the US Constitution, federal domestic law and treaties are on equal footing. Although a Court will attempt to give effect to both when they relate to the same subject, if there is a clear conflict between a treaty and federal law, the later in time authority will prevail.

4. Judicial precedents

Anti-abuse measures in the US are generally considered to originate from the US Supreme Court decision in the case of *Gregory v Helvering* which laid the foundation of the economic substance doctrine. A few important cases are discussed below.

- ***Gregory v. Helvering***¹²⁹. In this case, Gregory (the taxpayer) wished to transfer stock from a corporation she wholly owned to herself. Had she done so directly, the transfer would have been treated as a taxable dividend. Instead, in an attempt to avoid taxation, Gregory formed a new corporation, transferred the stock there, liquidated the newly formed corporation, and claimed its assets. She argued that, this transaction should have no tax consequences because she had received the stock "in pursuance of a plan of corporate reorganisation." Although the transaction satisfied the literal terms of the statute, the Court sided with the Commissioner, condemning the

transaction as an "elaborate and devious form of conveyance masquerading as a corporate reorganisation." The Court determined that to allow Gregory to avoid taxation would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose".

- In ***Del Commercial Properties Inc. v. Commissioner***¹³⁰, the District of Columbia Court of Appeals held that Del Commercial Properties Inc. (Commercial), a US corporation, was liable for withholding tax in a back-to-back loan transaction. In this case Delcon Financial Ltd (Financial), a Canadian corporation and an affiliate of Commercial obtained a USD18 million loan from a third party bank. Financial then loaned USD14 million of the loan to its wholly owned Canadian subsidiary, which then contributed USD14 million to its wholly owned Cayman subsidiary, which contributed the USD14 million to its wholly owned Antilles subsidiary, which contributed the USD14 million to its wholly owned Netherlands subsidiary (BV). BV then loaned the USD14 million to Commercial. Although the taxpayer had at first made its loan payments to BV (which then transferred the payments to Financial or Financial's Canadian subsidiary), it began making loan payments directly to Financial after a year and a half. The taxpayer claimed that the loan from BV to Commercial

should be respected and that its interest payments to BV were not subject to withholding tax under the USA-Netherlands tax treaty. The IRS argued that the loan was actually from Financial to Commercial and that the interest payments were subject to withholding tax under the USA-Canada tax treaty. The transaction was analysed under the step transaction doctrine where it was observed that a step in a series of transactions is ignored if the step does not appreciably affect the taxpayer's beneficial interest except to reduce his tax. It was observed that for the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose.

¹²⁹ *Gregory v. Helvering*, 293 U.S. 465 (1935)

¹³⁰ *Del Commercial Properties Inc. v. Commissioner*, 251 F.3d 210 (DC Cir. 2001)

Annexure C

Text of GAAR Provisions under the Code

- 123 (1) Any arrangement entered into by a person may be declared as an impermissible avoidance arrangement and the consequences, under this Code, of the arrangement may be determined by—
- (a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement;
 - (b) treating the impermissible avoidance arrangement—
 - (i) as if it had not been entered into or carried out; or
 - (ii) in such other manner as in the circumstances of the case, the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit;
 - (c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
 - (d) deeming persons who are connected persons in relation to each other to be one and the same person;
 - (e) reallocating, amongst the parties to the arrangement—
 - (i) any accrual, or receipt, of a capital or revenue nature; or
 - (ii) any expenditure, deduction, relief or rebate; or
 - (f) recharacterising—
 - (i) any equity into debt or vice versa;
 - (ii) any accrual, or receipt, of a capital or revenue nature; or
 - (iii) any expenditure, deduction, relief or rebate.
- (2) The provisions of sub-section (1) may be applied in the alternative for, or in addition to, any other basis for determination of tax liability in accordance with such guidelines as may be prescribed.
- (3) The provisions of this section shall apply subject to such conditions and in the manner as may be prescribed.
124. In this Chapter,—
- (1) “accommodating party” means a party to an arrangement who, as a direct or indirect result of his participation, derives any amount in connection with the arrangement, which shall—
- (a) be included in his total income which would have otherwise been included in the total income of another party;
 - (b) not be included in his total income which would have otherwise been included in the total income of another party;
 - (c) be treated as a deductible expenditure, or allowable loss, by the party which would have otherwise constituted a non-deductible expenditure, or non allowable loss, in the hands of another party; or
 - (d) result in pre-payment by any other party;
- (2) “arm’s length price” means a price which is applied, or proposed to be applied, in a transaction between persons, enterprises or undertakings, other than associated enterprises, in uncontrolled, unrelated or independent conditions;
- (3) “arrangement” means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes any of the above involving the alienation of property;

- (4) “asset” includes property, or right, of any kind;
- (5) “associated enterprise” in relation to another enterprise, means an enterprise—
- (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise, and for the purposes of sub-clauses (a) and (b) above, two enterprises, shall be deemed to be associated enterprises at any time during the financial year, if they are associated with each other by virtue of—
- (i) one enterprise holding, directly or indirectly, shares carrying twenty six per cent. or more of the voting power in the other enterprise;
- (ii) any person or enterprise holding, directly or indirectly, shares carrying twenty-six per cent. or more of the voting power in each of such enterprises;
- (iii) a loan advanced by one enterprise to the other enterprise and the loan constitutes fifty-one per cent. or more of the book value of the total assets of the other enterprise;
- (iv) one enterprise guarantees ten per cent. or more of the total borrowings of the other enterprise;
- (v) more than one-half of the board of directors, or members, of the governing board, or one or more executive directors, or executive members, of the governing board of one enterprise, being appointed by the other enterprise;
- (vi) more than one-half of the directors, or members, of the governing board, or one or more of the executive directors, or executive members, of the governing board, of each of the two enterprises, being appointed by the same person or persons;
- (vii) the manufacture, or processing, of any goods or articles of, or carrying on the business by, one enterprise being wholly dependent on the use of know-how, patents, copyrights, trade marks, brands, licences, franchises, or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights;
- (viii) ninety per cent. or more of the raw materials and consumables required for the manufacture, or processing, of goods or articles carried out by one enterprise, being supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise;
- (ix) the goods or articles manufactured, or processed, by one enterprise, being sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise;
- (x) the services provided, directly or indirectly, by one enterprise to another enterprise or to persons specified by the other enterprise, and the amount payable and the other conditions relating thereto are influenced by such other enterprise;

- (xi) one enterprise being controlled by an individual, and the other enterprise being also controlled by such individual or his relative, or jointly by such individual and his relative;
 - (xii) one enterprise being controlled by a Hindu undivided family, and the other enterprise being also controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative;
 - (xiii) one enterprise holding ten per cent., or more, interest in another enterprise being an unincorporated body;
 - (xiv) any specific or distinct location of either of the enterprises as may be prescribed; or
 - (xv) any other relationship of mutual interest, existing between the two enterprises, as may be prescribed;
- (6) “associated operation” in relation to any transfer means an operation of any kind effected by the transferor in relation to—
- (a) any asset transferred;
 - (b) any asset representing, directly or indirectly, any asset so transferred;
 - (c) the income accruing from any asset so transferred; or
 - (d) any asset representing, directly or indirectly, the accumulation of income accruing from any asset so transferred;
- (7) “associated person” in relation to a person, means—
- (a) any relative of the person, if the person is an individual;
 - (b) any director of the company or any relative of such director, if the person is a company;
 - (c) any participant in an unincorporated body or any relative of such participant, if the person is an unincorporated body;
 - (d) any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family;
 - (e) any individual who has a substantial interest in the business of the person or any relative of such individual;
 - (f) a company, unincorporated body or Hindu undivided family having a substantial interest in the business of the person or any director, participant, or member of the company, body or family, or any relative of such director, participant or member;
 - (g) a company, unincorporated body or Hindu undivided family, whose director, participant, or member have a substantial interest in the business of the person; or family or any relative of such director, participant or member;
 - (h) any other person who carries on a business, if—
 - (i) the person being an individual, or any relative of such person, has a substantial interest in the business of that other person; or
 - (ii) the person being a company, unincorporated body or Hindu undivided family, or any director, participant or member of such company, body or family, or any relative of such director, participant or member, has a substantial interest in the business of that other person;
- (8) “benefit” includes a payment of any kind;
- (9) “broken period income” shall be calculated as if the income from such securities had accrued from day to day and been apportioned accordingly for the broken period;
- (10) “bona fide purpose” shall not include any purpose which—
- (a) has created rights or obligations that would not normally be created between persons dealing at arm’s length; or
 - (b) would result, directly or indirectly, in the misuse, or abuse, of the provisions of this Code;
- (11) “capital sum” means—
- (a) any sum paid by way of a loan or repayment of a loan; or
 - (b) any other sum paid otherwise than as income, being a sum which is not paid for full consideration in money or money’s worth;
- (12) “connected persons” includes associated persons;
- (13) “enterprise” in relation to an international transaction includes—
- (a) a person who is, or has been, or is likely to be, engaged in any business, industrial, commercial, financial, construction, mining, research, investment or any other similar activity, whether such activity is carried on directly or through one, or more, of its units, divisions or subsidiaries, wherever located; and
 - (b) the permanent establishment of the person referred to in sub-clause (a);
- (14) “funds” includes—
- (a) any cash;
 - (b) cash equivalents; and
 - (c) any right, or obligation, to receive, or pay, the cash or cash equivalent;

- (15) “impermissible avoidance arrangement” means a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit and it—
- (a) creates rights, or obligations, which would not normally be created between persons dealing at arm’s length;
 - (b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Code;
 - (c) lacks commercial substance, in whole or in part; or
 - (d) is entered into, or carried out, by means, or in a manner, which would not normally be employed for bona fide purposes;
- (16) “intangible property” includes know-how, patents, goodwill, copyrights, trade-marks, brand name, licences, franchises, any business or commercial rights, leasehold interest, exploration and exploitation rights, easement rights, air rights, water rights, or any other thing that derives its value from its intellectual content instead of its physical attributes;
- (17) “international transaction” means—
- (a) a transaction between two or more associated enterprises, either or all of whom is a non-resident, in the nature of—
 - (i) purchase, sale or lease, of tangible or intangible property;
 - (ii) supply of service;
 - (iii) lending, or borrowing, money;
 - (iv) any other transaction, which has a bearing on the income, loss or asset of any one or more of the enterprises; or
 - (v) a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred, or to be incurred, in connection with a benefit, service or facility provided, or to be provided, to any one or more of the enterprises;
 - (b) a transaction entered into by two or more persons, not being associated enterprises, if—
 - (i) the transaction is of the nature referred to in sub-clause (a);
 - (ii) there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; and
 - (iii) either, or both, of the associated enterprises is a non-resident;
- (18) “interest” includes dividend;
- (19) “lacks commercial substance”-a step in, or a part or whole of, an arrangement shall be deemed to be lacking commercial substance, if—
- (a) it does not have a significant effect upon the business risks, or net cash flows, of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained but for the provisions of section 123;
 - (b) the legal substance, or effect, of the arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
 - (c) it includes, or involves—
 - (i) round trip financing without regard to,—
 - (A) whether or not the round tripped amounts can be traced to funds transferred to, or received by, any party in connection with the arrangement;
 - (B) the time, or sequence, in which round tripped amounts are transferred or received; or
 - (C) the means by, or manner in, which round tripped amounts are transferred or received;
 - (ii) an accommodating or tax indifferent party;
 - (iii) any element that have the effect of offsetting or cancelling each other; or
 - (iv) a transaction which is conducted through one or more persons and disguises the nature, location, source, ownership, or control, of the fund;
- (20) “party” means party to the arrangement;
- (21) “round trip financing” includes financing in which—
- (a) funds are transferred among the parties to the arrangement; and
 - (b) the transfer of the funds would—
 - (i) result, directly or indirectly, in a tax benefit but for the provisions of section 123; or
 - (ii) significantly reduce, offset or eliminate any business risk incurred by any party to the arrangement;
- (22) “safe harbour”, in relation to computation of arm’s length price, means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee;
- (23) “similar security” means security which entitles its holder to the same rights against the same person as to capital and interest and the same remedies for the enforcement of those rights, irrespective of any difference in the—
- (a) total nominal amounts of the respective security;
 - (b) form in which it is held; or
 - (c) manner in which it can be transferred;
- (24) “substantial interest in the business” a person shall be deemed to have a substantial interest in the business, if—
- (a) in case where the business is carried on by a company, such person is, at any time during the financial year, the beneficial owner of equity shares carrying twenty per cent. or more, of the voting power; or
 - (b) in any other case, such person is, at any time during the financial year, beneficially entitled to twenty per cent. or more, of the profits of such business.

- (25) “tax benefit” means—
- (a) a reduction, avoidance or deferral of tax or other amount payable under this Code;
 - (b) an increase in a refund of tax or other amount under this Code;
 - (c) a reduction, avoidance or deferral of tax or other amount that would be payable under this Code but for a tax treaty;
 - (d) an increase in a refund of tax or other amount under this Code as a result of a tax treaty; or
 - (e) a reduction in tax bases including increase in loss, in the relevant financial year or any other financial year.
- (26) “transaction” in relation to an international transaction shall include an arrangement, understanding or action in concert—
- (a) whether or not such arrangement, understanding or action is formal or in writing; or
 - (b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding;
- (27) “transaction relating to buy and sale back of security” means a transaction where a person buys a security, and sells or transfers the same, or similar, security;
- (28) “transaction relating to sale and buy back of security” means a transaction where a person, being the owner of any security, sells or transfers the security, and buys back or re-acquires the same, or similar, security;
- (29) “transfer” in relation to any right includes the creation of a right.
125. (1) An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit unless the person obtaining the tax benefit proves that obtaining the tax benefit was not the main purpose of the arrangement.
- (2) 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 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.
154. (1) The Commissioner shall, for the purposes of section 123, serve on the assessee a notice requiring him, on a date to be specified therein to produce, or cause to be produced, any evidence or particulars on which the assessee may rely in support of his claim that the provisions of section 123 are not applicable to him.
- (2) After hearing the evidence and after taking into account such particulars as the assessee may produce, the Commissioner shall pass an order declaring an arrangement as being an impermissible avoidance agreement or otherwise for the purposes of section 123.
- (3) Upon declaring an arrangement as an impermissible avoidance agreement, the Commissioner shall—
- (a) issue directions to the AO to make such adjustment to the total income, or the tax liability, of the assessee; and
 - (b) forward or cause to be forwarded a copy of such order—
 - (i) to the assessee; and
 - (ii) to the jurisdictional Commissioner of the other party to the arrangement, who shall then proceed under this section against such other party and the provisions of this section shall apply accordingly.
- (4) No order under sub-section (2) shall be issued after a period of twelve months from the end of the month in which the notice under sub-section (1) is issued.

291. (1) The Central Government may enter into an agreement with the Government of any other country—
- (a) for the granting of relief in respect of—
 - (i) income or wealth on which income-tax or wealth-tax, as the case may be, has been paid both under this Code and under the corresponding law in force in that country; or
 - (ii) income-tax or wealth-tax chargeable under this Code and under the corresponding law in force in that country to promote mutual economic relations, trade and investment;
 - (b) for the avoidance of double taxation of income or wealth under this Code and under the corresponding law in force in that country;
 - (c) for exchange of information for the prevention of evasion or avoidance of income-tax or wealth-tax chargeable under this Code or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance;
 - (d) for recovery of income-tax or wealth-tax under this Code and under the corresponding law in force in that country; or
 - (e) for carrying out any other purpose of this Code not expressly covered under clauses (a) to (d) above or the corresponding law in force in that country.
- (2) The Central Government may enter into an agreement with the Government of any specified territory outside India for the purposes specified in sub-section (1).
 - (3) The Central Government may, by notification, make such provisions as may be necessary for implementing the agreements referred to in sub-sections (1) and (2).
 - (4) Any specified association in India may enter into an agreement with any specified association in the specified territory outside India for the purposes of sub-section (1) and the Central Government may by notification make such provisions as may be necessary for adopting and implementing such agreement.
 - (5) A person shall not be entitled to claim relief under the provisions of the agreement unless a certificate of his being a resident in the other country or specified territory is obtained by him from the tax authority of that country or specified territory, in such form as may be prescribed.
 - (6) The provisions of this Code shall not be regarded as discriminatory against the foreign company merely on the consideration that the liability of the foreign company to pay tax is calculated at a rate higher than the rate at which the liability of a domestic company is calculated.
 - (7) Any term used but not defined in this Code or in the agreement referred to in subsections (1), (2) or sub-section (4) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Code or the Agreement, have the meaning assigned to it in the notification issued by the Central Government.
 - (8) Where the Central Government has entered into an agreement under sub-section (1) or sub-section (2), or has adopted an agreement entered into by the specified association under sub-section (4), as the case may be, then the provisions of this Code shall apply in relation to the assessee to whom such agreement applies, to the extent they are more beneficial to him.
 - (9) Notwithstanding anything in sub-section (8), the provisions of this Code relating to—
 - (a) General Anti-avoidance Rule under section 123;
 - (b) levy of Branch Profit Tax under section 111; or
 - (c) Control Foreign Company Rules referred to in the Twentieth Schedule, shall apply to the assessee referred to in sub-section (8), whether or not such provisions are beneficial to him.

Abbreviations

AAR	Authority for Advance Ruling
Act	Income-tax Act, 1961
AE	Associated Enterprise
AO	Assessing Officer
ATO	Australian Taxation Office
AUD	Australian Dollars
AY	Assessment Year
CIT	Commissioner of Income-tax
CIT Law	Corporate Income Tax law
CCA	Capital Cost Allowance
Code	Direct Taxes Code Bill, 2010
CRA	Canada Revenue Agency
DOTA	Disclosure of Tax Avoidance Schemes
DRP	Dispute Resolution Panel
DTC 2009	Draft Direct Taxes Code Bill, 2009
FDI	Foreign Direct Investment
FIPB	Foreign Investment Promotion Board
FTC	Foreign Tax Credit
GAAR	General Anti-avoidance Rule
GBP	Pounds Sterling
GTC	German Tax Code

GT Court	German Federal Tax Court
IC	Information Circular
IRS	Internal Revenue Service
ITAA	Income Tax Assessment Act, 1936, Australia
ITAT	Income-tax Appellate Tribunal
LLP	Limited Liability Partnership
LOB	Limitation of Benefits
OECD	The Organisation for Economic Co-operation and Development
PE	Permanent Establishment
Rs.	Indian Rupees
SAAR	Specific Anti-avoidance Rules
SARS	South African Revenue Services
SAT	State Administration of Taxation
SPV	Special Purpose Vehicles
TAAR	Targeted Anti-avoidance Rules
TIEA	Tax Information Exchange Agreements
TP	Transfer Pricing
UK	United Kingdom
UN	United Nations
UN MC	United Nations Model Convention
US	United States
USD	United States Dollars

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Contacts

Ahmedabad

Nikhil Bhatia
President Plaza, 1st Floor
Plot No. 36, Opposite Muktidham
Derasar Thaltej Cross Roads, S G
Highway Ahmedabad 380054
Phone: +91 79 3091 7000
Email nikhil.bhatia@in.pwc.com

Bangalore

Indraneel R Chaudhury
6th Floor, Tower "D"
The Millenia
1 & 2 Murphy Road, Ulsoor
Bangalore 560 008
Phone: +91 80 4079 7000
Email indraneel.r.chaudhury@in.pwc.com

Chennai

K Venkatachalam
32, Khader Nawaz Khan Road
Nungambakkam
Chennai 600 006
Phone: +91 44 4228 5000
Email k.venkatachalam@in.pwc.com

Hyderabad

R D Hingwala
8-2-293/82/A/113A
Road No.36,
Jubilee Hills
Hyderabad 500 034
Phone: +91 40 6624 6600
Email r.d.hingwala@in.pwc.com

Kolkata

Somnath Ballav
South City Pinnacle
4th Floor, Plot # X1/1
Block EP, Sector 5, Salt Lake
Electronic Complex,
Kolkata 700 091
Phone: +91 33 4404 6000
Email somnath.ballav@in.pwc.com

Mumbai

Ketan Dalal
PwC House, Plot No.18/A
Gurunanak Road (Station Road)
Bandra (West), Mumbai 400 050
Phone: +91 22 6689 1000
Email ketan.dalal@in.pwc.com

New Delhi/ Gurgaon

Shyamal Mukherjee
Building no. 10, 17th Floor
Tower -C, DLF Cyber City
Gurgaon 122002
Phone: +91 124 3306 6000
Email shyamal.mukherjee@in.pwc.com

Pune

Sandip Mukherjee
GF-02, Tower C Panchshil Tech Park Don
Bosco School Road
Yerwada, Pune - 411 006
Phone: +91 20 4100 4444
Email sandip.mukherjee@in.pwc.com

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