# Journey of concepts of Tax Planning as laid down by the Courts to legislative changes, by way of GAAR, BEPS etc

**32nd Regional Conference of WIRC**

3rd September 2017

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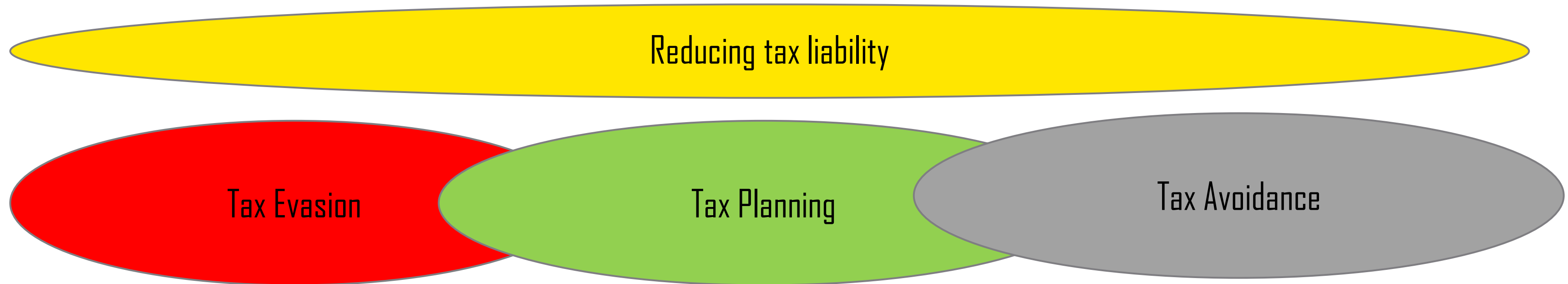
# Tax planning, avoidance and evasion




| Tax evasion | Tax planning | Tax avoidance |
|---|---|---|
| Illegal and unacceptable | Legal | Not illegal *per se* – but "possibly" against the spirit of law |
| Availing tax benefits through unfair means | Availing tax benefits through compliance in law and in spirit | Availing tax benefits by taking advantage of loopholes in law |
| Stating an untrue statement knowingly, submitting misleading documents, suppression of facts, omission of material facts, etc. | Using fiscal incentive by submitting to the conditions and economic consequences of tax legislation | An outcome of actions none of which or no combination of which is illegal or forbidden by the law. |

# Jurisprudence

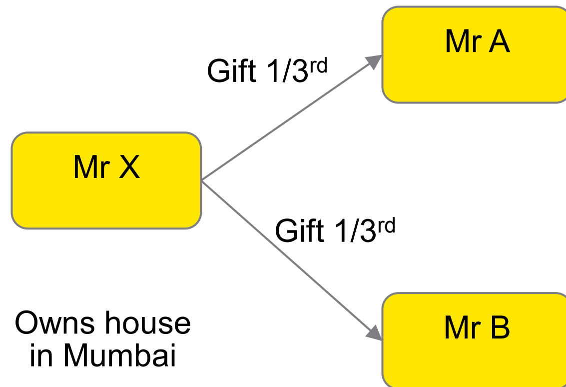
| Judgement | Held |
|---|---|
| **IRC v Duke of Westminster [(1936) 19 TC 49 AC 1]** | Lord Tomlin in the case of IRC v Duke of Westminster captured the essence of the notion of tax planning "every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". |
| **A Raman & Co (67 ITR 11) (SC) (1968)** | "Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented." |
| **WT Ramsay Ltd v IRC ([1981] STC 174)** | It was held that where a transaction has pre-arranged artificial steps that serve no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole. |
| **McDowell (154 ITR 148) (SC) (1985)** | Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods (Justice Reddy in McDowell) |
| **Craven v White ([1988] STC 476 HL)** | It was held that Revenue cannot start with the question as to whether the transaction was a tax deferment/tax-saving device but that Revenue should look at the transaction as a whole to ascertain its true legal nature. Post Craven, the House continued to uphold the Duke of Westminster principle in subsequent rulings. |

# Jurisprudence

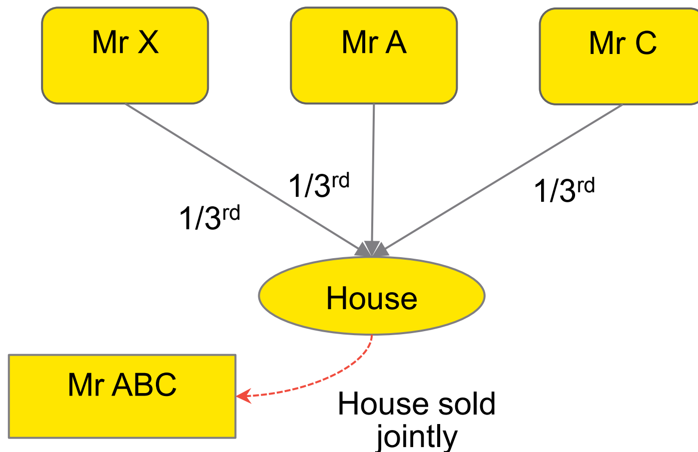
| Judgement | Held |
| --- | --- |
| **Azadi Bachao (263 ITR 706) (SC) (2003)** | "An act which is otherwise valid in law cannot be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests<br>McDowell cannot be read as laying down that every attempt of tax planning is illegitimate" |
| **Vodafone (341 ITR 1) (SC) (2012)** | "Every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and he is not bound to choose that pattern which will replenish the treasury" (Justice Radhakrishnan) |
| **CIT v/s Walfort Share & Stock Brokers (P) Ltd. (SC)(326 ITR 1) (2010)<br>(Dividend Stripping case)** | It was held that, even assuming that the transaction in that case was pre-planned, there is nothing to impeach the genuineness of the transaction, and hence the loss arising in the course of a dividend stripping transaction before the insertion of section 94(7) with effect from 1st April, 2002 cannot be disallowed; dividend stripping transaction cannot be said to be 'abuse of law' even if it was pre-planned |

Case studies

# Case Study 1 – Family Settlement




Post Gift




- Mr X has 2 Sons, namely Mr A and Mr B
- Mr X has an ancestral house in Mumbai
- Mr X wants to sell the ancestral house and buy 3 separate houses for self & 2 sons
- Accordingly, Mr X gifts 1/3rd Share in the house to Mr A & Mr B in December 2016
- Mr X, Mr A and Mr B jointly sold their share of the property to Mr ABC in 2017
- They buy 3 separate houses and claim exemption u/s 54 on the Capital gains arising from sale of their 1/3rd share of house

# Case Study 1 – Family Settlement

Issue

- Whether the transaction is for purpose of tax Avoidance or it is a legitimate tax planning?
- If the transaction was after 1 April 2017, whether GAAR provisions can be invoked?

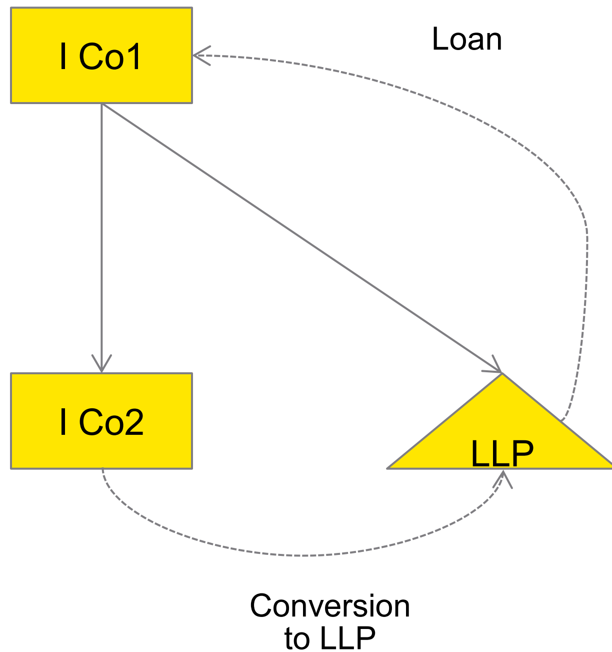
Possible Interpretation

- The gift of property by father to sons is legitimate transaction. Claiming exemption u/s 54 is permitted within framework of law. Intention is not to avoid tax

Interpretation by courts as to tax planning:

- The decision of House of Lords of 1936 in case of **IRC v Duke of Westminster** has held that *every person is entitled to arrange his affairs in manner to minimise taxes within the framework of law*
- The said decision was upheld by Indian Court in following cases:
  - A Raman & Co (67 ITR 11) (SC) (1968)
  - Arvind Narottam (173 ITR 479) (SC)(1988)
  - Banyan & Berry (222 ITR 831) (Gujarat High Court) (1995)
- If it proved that the sole motive of the transaction is to evade tax, the GAAR provisions can be invoked if transaction was after 1/4/2017

# Case Study 2 – Conversion of Company to LLP and interest free loans to holding company




- I Co1 has a cash rich subsidiary I Co2
- I Co1 requires funds for investment
- I Co2 is converted to an LLP
- LLP gives a interest free loan to I Co1

## Issues

- Whether it is legitimate tax planning vs tax avoidance?
- Is S. 2(22)(e) not applicable to LLP?
- Can tax authorities apply GAAR and recharacterize LLP as a company and treat it as a loan by company to its shareholder?

# Case Study 2 – Conversion of Company to LLP and interest free loans to holding company

Possible View 1

- Conversion into LLP is within ambit of law,
- It is planning to avoid taxes without breaking the law

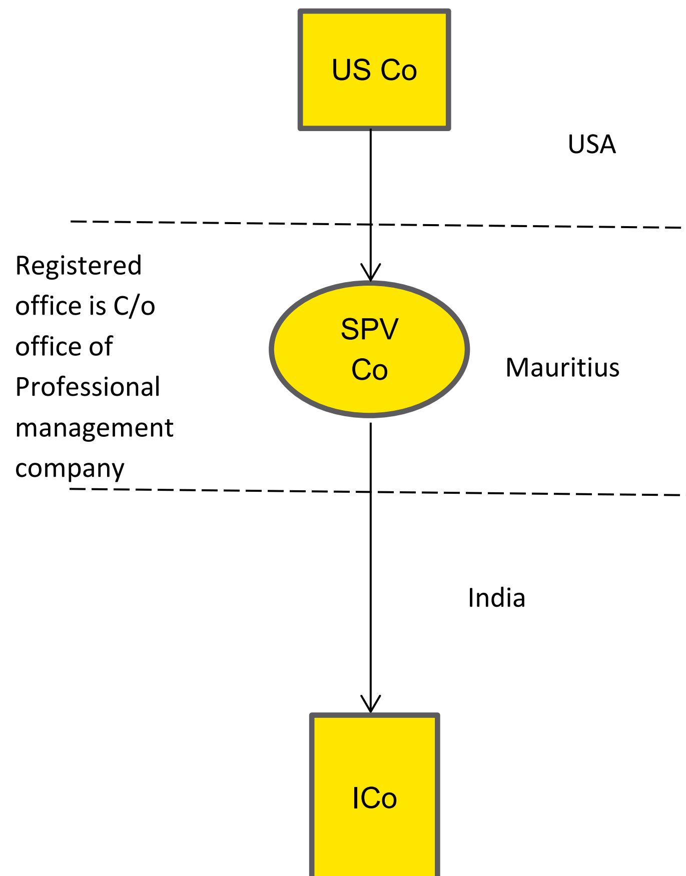
Possible View 2

- Entire transaction is colorable device with sole motive to avoid taxes

Interpretation by courts as to tax planning & tax avoidance:

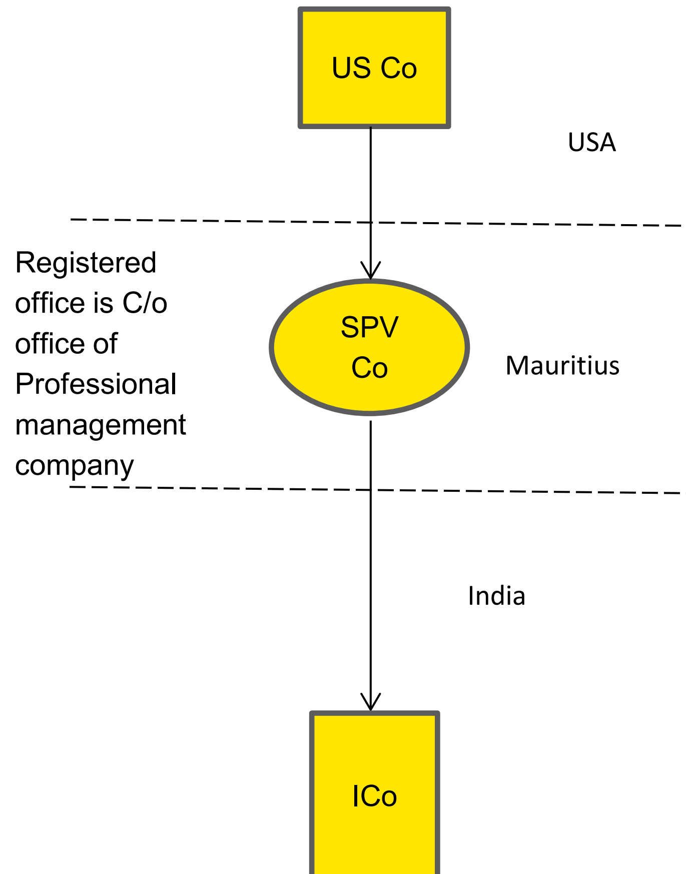
- The decision of House of Lords in 1936 in the case of **IRC v Duke of Westminster and other decision by Indian Courts have** held that every person is entitled to arrange his affairs in manner to minimise taxes within the framework of law
- However, House of Lords in case of **W T Ramsay ([1981] STC 174)** held that where a transaction has pre-arranged artificial steps that serve no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole
- Subsequently, Supreme Court in India in case of **McDowell (154 ITR 148) (SC) (1985)** held that colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods
- If it proved that the sole motive of the transaction is to evade tax, the GAAR provisions can be invoked if transaction was after 1/4/2017 and apply provisions of Section 2(22)(e) to tax the same

# Case Study 3 - Inbound investment from Mauritius




- US Co is a company incorporated in the United States of America ('USA') and a tax resident of USA
- US Co is a global conglomerate having subsidiaries in various jurisdictions across the world
- US Co has set-up 100 percent subsidiary in Mauritius, M Co
- M Co is a tax resident of Mauritius, holding a tax residency certificate issued by the Mauritius Revenue Authorities
- M Co was set-up in 2006 to act as a SPV for investments into India and other Asia Pacific countries
- M Co's registered office is situated out of professional management company in Mauritius

# Case Study 3 - Inbound investment from Mauritius




- Professional Management Company's employee and Director of US Co are on BOD of M Co
- Board meetings of M Co are held in Mauritius and director of US Co attend the meetings over a call/ Video conference
- M Co has made investment in ICo since FY 2006.
- In case of further investments made by M Co in India – US Co gives loan/ infuses fresh equity in M Co
- M Co has sold its investment in I Co in December 2016

Issue:

- Whether the capital gains arising on sale of investment in India is liable to tax?
- Whether its Tax Planning vs Tax avoidance?
- Whether transaction will be grand fathered?

# Case Study 3 - Inbound investment from Mauritius

Possible View

- SPV has been formed in Mauritius and investments in India have been routed through the same in order to claim India-Mauritius treaty benefit which is within ambit of law
- It is planning to avoid taxes without breaking the law

Interpretation by courts as to tax planning & tax avoidance:

- Supreme Court in case of **Azadi Bachao (263 ITR 706) (2003)** has held that an act which is otherwise valid in law cannot be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests. Further, referring to decision in case of McDowell (154 ITR 148) (SC) (1985)**,** the court in case of Azadi Bachao (Supra) observed that every attempt of tax planning cannot be treated as illegitimate
- Subsequently, Supreme Court in case of **Vodafone (341 ITR 1)(2012)** has re-affirmed the view in case of Azadi Bachao (Supra) other past decisions of Supreme Court. Further, it laid down that it is required to look into the substance of the transaction as a whole to understand the purpose of the transaction.

Amendment of DTAA between India and Mauritius on 10 May 2016

- Post the amendment gains from the transfer of shares acquired before 1 April, 2017 will not be taxable in India even if the shares are transferred on or after 31 March, 2017. India will have the right to tax capital gains arising from the sale of shares in an Indian company, if such shares have been acquired on or after 1 April, 2017.

Specific Anti Avoidance Rules

# Specific Anti-Avoidance Rules (SAAR)

- Tax laws designed to deal with particular transactions of a concern are termed as SAAR. SAAR is a deterrent provision introduced to discourage tax payers from resorting to tax evasion measures with respect to specific transactions. Several such provisions present in Income-tax Act, 1961

| SAAR under the ITA | SAAR under DTAA |
|---|---|
| Deemed Dividend on loans to shareholders - S.2(22)(e)<br>*Pvt Ltd companies generally give interest-free loans/ advances to their directors / family members who are shareholders haveing 10% or more voting power or to concern in which such shareholder has substantial interest. Such loan/ advances are treated as deemed dividend covered under S 2(22)(e) and are taxable in the hands of shareholders.* | Arm's Length Price- Article 9<br>*Article 9 aims to make adjustments to tax profits when such profits are lower due to conditions imposed between related parties which are different from those imposed between independent enterprises* |
| Indirect transfer<br>*Introduced in 2012, with retrospective effect from 1961, shares of foreign company are deemed to be situated in India if, directly or indirectly, it derives, its value substantially from assets located in India. Definition of capital asset was amended to include rights in or in relation to an Indian company including management rights, control or any other rights* | Beneficial Ownership- Article 10, 11 & 12<br>*The term beneficial owner was adopted to clarify that the benefits of the treaty were not intended to be conferred on recipients with minimal ownership rights – i.e. intermediaries / agents/ nominees. This was to ensure 'substance over form'.* |
| Transaction with Notified Jurisdictional Area- S.94A<br>*S. 94A empowers the Govt to black list certain non-cooperative foreign tax jurisdiction with which India does not have effective exchange of tax information system and treat them as notified jurisdiction area.* | Subject to Tax Clause- Article 4<br>*In order to prevent treaty shopping and use of hybrid entities, certain treaties specifically provide for treaty benefits to certain entities such as partnerships, trust, to the extent income derived by such entities are "subject to tax" in that jurisdiction in the hands of its partners, members.* |

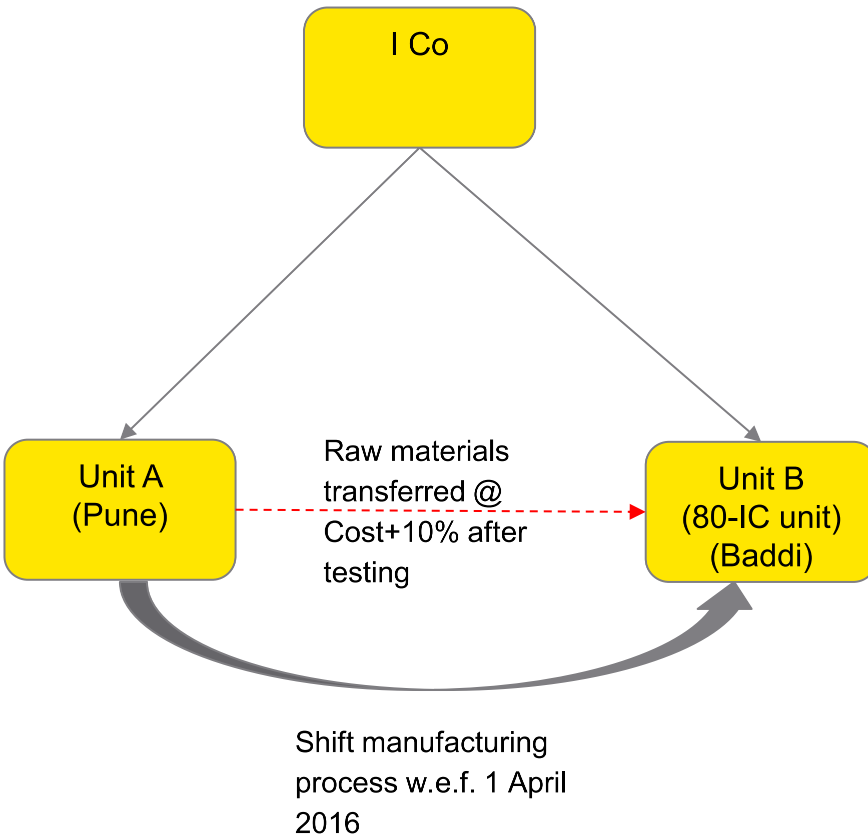
# Specific Anti-Avoidance Rules (SAAR)

| SAAR under the ITA | SAAR under DTAA |
|---|---|
| <u>Related Party Transaction-S.40A(2)</u><br>*S. 40A(2) provides power to AO, wherein if he is of the opinion that such expenditure incurred and payment made or to be made to certain specified person is excessive and unreasonable with regard to the fair market value, he may disallow such expense as he considers to be excessive & unreasonable.* | <u>Limitation of Benefits ('LOB')</u><br>*LOB clause in the DTAAs intend to prevent misuse of tax treaties by third country residents. The objective conditions are included to restrict treaty benefits to only to bonafide cases (India US DTAA is India's first DTAA with an LOB article)* |
| <u>Transaction resulting in transfer of Income to NR- S.93</u><br>*In cases where there is transfer of assets and income becomes payable to a NR as a consequence of transfer by itself or in conjunction with associated operations, such income would be chargeable to tax in the hands of the transferor.* | |
| <u>Introduction of Thin Capitalization rules - S.94B</u><br>*Thin capitalisation refers to a situation where an entity is highly geared, that is, has high proportion of debt as compared to equity. Assessees have been deduction of interest expenses from their taxable income. Accordingly, in 2017, S 94B was insterted so as to restrict deduction towards interest paid to non-resident Aes* | |
| <u>Buy Back of Shares- S.115QA</u><br>*Prior to 2013, buyback of shares by WOS/ subsidiary from intermediary/ parent in a tax favorable jurisdictions were considered as a tax avoidance scheme by tax authorities. Accordingly, in 2013, S 115QA was inserted to tax the difference between consideration paid by company and amount received on issue of shares (not being shares listed on recognised stock exchange)* | |

# Specific Anti-Avoidance Rules (SAAR)

| SAAR under the ITA | SAAR under DTAA |
| --- | --- |
| Undervaluation of Transactions - S.56(2)(vii), (viia), (viib), (x)<br>These provisions were introduced to counter laundering of unaccounted income. In various situations, difference between FMV and consideration paid was to be treated as income in the hands of recipient. | |
| S.40A(3), S.69D, S.269SS/T, S.115BBC<br>These provisions were introduced to discourage cash transactions, unaccounted transactions | |
| Abuse of Incentive Tax Benefit- S.80A(6), 80IA(8), 80IA(10), 78, 79, 72A<br>These provisions were introduced to regulate profit linked tax deductions claimed by eligible business units<br>Restriction on carry forward of losses was also brought in to ensure continuity. Set off and carry forward of accumulated losses and unabsorbed depreciation in case of amalgamation were allowed subject to certain conditions as specified | |
| Clubbing of income provisions - S. 60, 61, 64<br>*These provisions were introduced to taxation of 'real owner' of income* | |
| Procedural checks and balances - 206AA, 281, 90(4)/90(5) | |
| Capital Gains- S.47A, 45(3), 50C, 50D | |

# Case Study 4- SAAR




- I Co is engaged in manufacturing of consumer goods out of Unit A located in Pune
- I Co has set-up Unit B at Baddi, Himachal Pradesh, for which it is eligible to claim deduction u/s 80-IC of the Act
- I Co shifted the manufacturing of consumer goods to Baddi w.e.f 1/4/2016
- The raw materials are procured and tested @ Pune facility and transferred Baddi Unit at Cost+10%
- Baddi completes manufacturing of the goods and sells it to distributors directly on which Company earns margin of 35%

Issue

- Whether the said shifting of business to tax holiday will be hit by SAAR

# Case Study 4 - SAAR

Possible View

- Unit B has been formed to claim benefit of 80-IC
- By virtue of SAAR provisions (80-IA(8)), transaction between, Unit A and Unit B (80-IC unit) has to be at arm's length
- Also, as per Domestic Transfer Pricing provisions it has to be seen whether transaction is at arm's length price
- Whether, Cost+10% charged by Unit A on raw materials procured is at arm's length needs to be evaluated

Use v/s Misuse v/s Abuse of provisions under the Act

- In case wherein specific provisions have been inserted in the Income-tax Act, the taxpayer is entitled to take benefit of the Act and arrange his affairs accordingly.
- Commercial justification and substance of the entire transaction should be considered. However, if the sole motive is to evade taxes, the courts can adopt a 'look through' approach.

# Case Study 4 - SAAR

Will GAAR be invoked if SAAR applies

- As per the CBDT Circular 7/ 2017, GAAR and SAAR can co-exist as applicable in facts of the case,
- Accordingly, GAAR can be invoked by the Department to look into the transaction, although the same would cause increased litigation and would be cumbersome.

Had SAAR provisions would not be there, it would have to been seen by Courts that whether starting business from 80-IC unit instead of existing unit is colorable device/ arrangement to avoid taxes

General Anti Avoidance Rules

# General Anti-Avoidance Rules (GAAR)

- GAAR is a concept within law that provides the taxing authority a mechanism to deny the tax benefits of transactions or arrangements believed not to have any commercial substance or purpose other than to generate the tax benefit(s) obtained

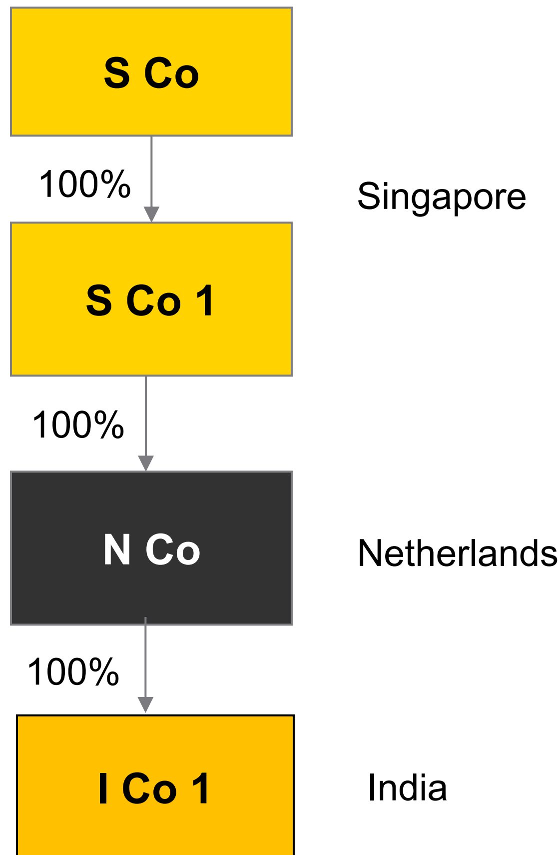
**Why GAAR?**

- Counteract and negate abusive tax avoidance arrangements which result in a serious loss of revenue to tax authorities
- Codify the principle of 'SUBSTANCE OVER FORM'
- Examine cases of aggressive tax planning with use of sophisticated structures
- Plugging loopholes that may result in tax avoidance
- Critical examination of inbound/outbound transaction and check treaty shopping
- Preserve the tax base of the country from erosion
- SAAR viewed as inadequate to combat aggressive tax avoidance

**Objectives of GAAR**

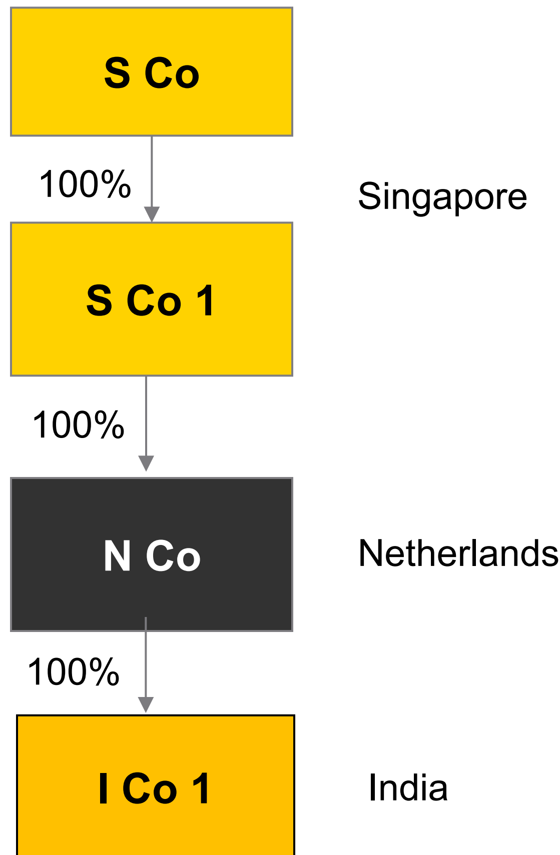
- Codify meaning of what constitutes abuse or avoidance of tax
- Target transactions which give tax benefits but are against spirit of law
- Provide the tax authority with a mechanism to eliminate the tax benefits claimed
- Allow the imposition of special assessments, penalties and interest where violations are determined

# Case study 5 – Grandfathering/ Impact on existing structures




- S Co is the ultimate parent company of a Singapore based group and is an operating company
  - Group has significant business operations in Singapore
- S Co 1 is the group's holding company for overseas business interests
- S Co and S Co 1 are tax residents of Singapore holding a tax residency certificate issued by the Singapore Revenue Authorities
- S Co 1 has a subsidiary, N Co which has invested into India
- N Co is a tax resident of Netherlands, holding a tax residency certificate issued by the Netherlands Revenue Authorities

# Case study 5 – Grandfathering/ Impact on existing structures




- N Co holds 100% shares of an Indian company I Co 1 since January 2005
- Negotiations are in progress with potential buyers which could result in:
  - N Co selling the shares of I Co 1 in FY 2016-17; or
  - S Co 1 selling the shares of N Co in FY 2017-18

Issue

- Whether the transactions will be grand-fathered under the GAAR provisions

# Case Study 5- Grandfathering/ Impact on existing structures

Possible Implications

- As per Rule 10U, GAAR shall not apply to *any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by,* ***any person from transfer of investments*** *made before the 1st day of April, 2017 by such person*
  - Where N Co sells shares of I Co in FY 2016-17, the same will be Grand-fathered as per Rule 10U
  - Where S Co 1 sells shares of N Co at less than arm's length price in FY 2017-18, the GAAR provisions can be invoked

Further, in case of sale of shares of N Co by S Co 1, provisions of Explanation 5 to Section 9(1)(i), can be invoked by the Department, since, N Co 1 being a investment holding company, derives substantial value from I Co.

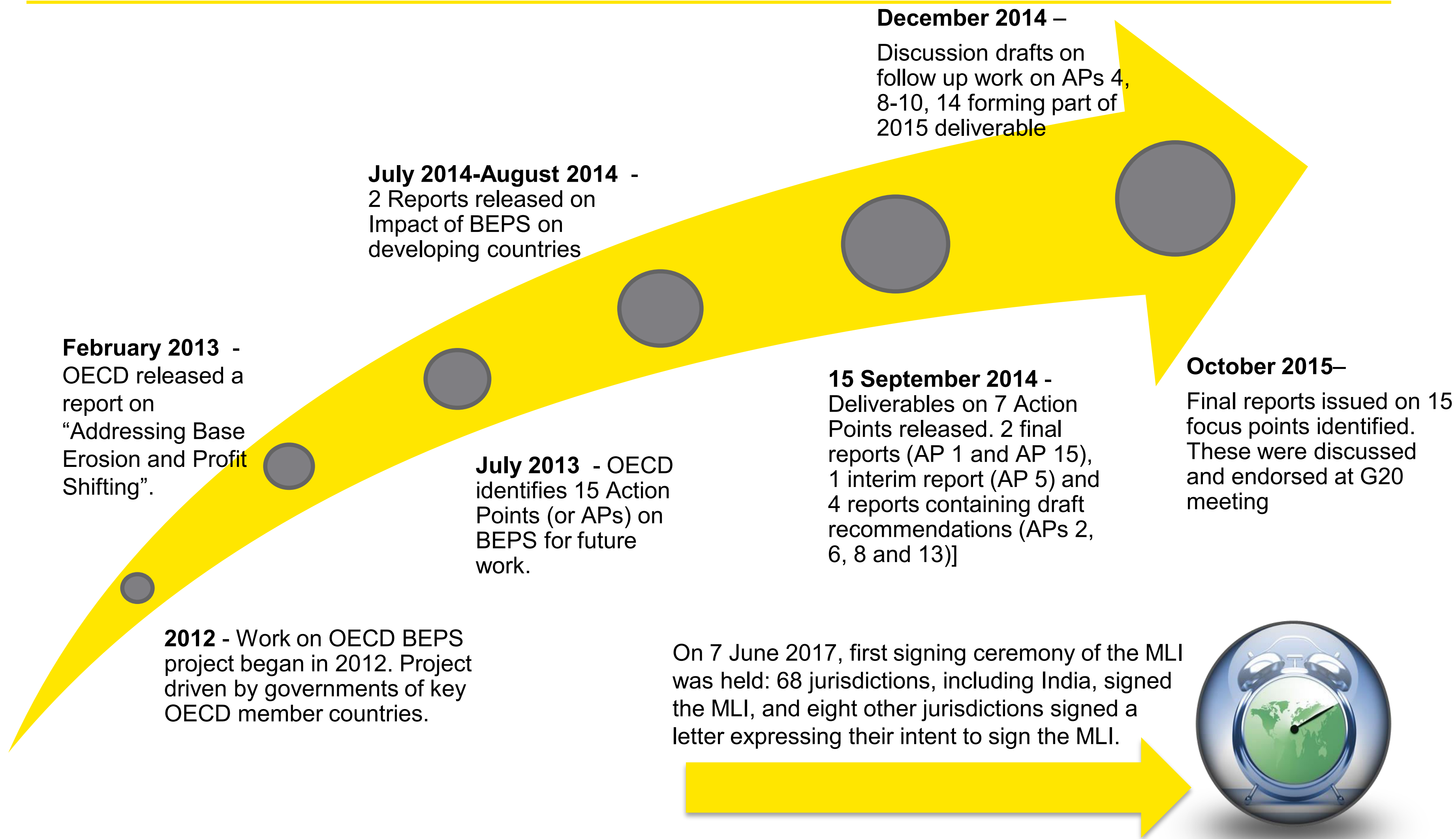
Had GAAR provisions would not be there, it would have to been seen by Courts whether sale of share by S Co1 of N Co is infact sale of business of I Co and whether it is a colorable device/ arrangement to avoid taxes

Base Erosion & Profit Shifting

# BEPS

- Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies which
  - exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes
  - shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid
- While treaties are meant for avoiding double taxation, urgent need and political commitment to address double non-taxation or less than single taxation
- Unless BEPS concerns met, there is drain on Government resources; harm to businesses and individuals who are not part of aggressive tax planning

# Chronology of events at OECD



# Thank You !