International Tax Planning in view of GAAR

Direct Tax Refresher Course, WIRC, ICAI

CA Vishal Gada

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GAAR – An Overview

GAAR – The Framework

Applicable to arrangements regarded as impermissible avoidance arrangement by the tax officer

Applicable for 1 April 2017

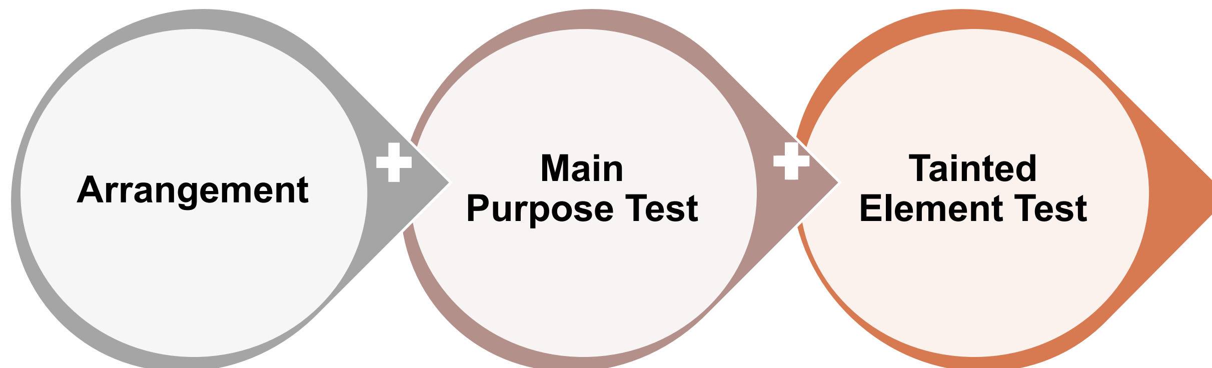
An impermissible avoidance arrangement means an ***arrangement,*** the ***main purpose*** of which is to obtain a ***tax benefit***, and it—

a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;

b) results, directly or indirectly, in the misuse or abuse of the provisions of this Act;

c) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or

d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes



Consequences of invoking GAAR

Wide ranging powers to the tax authorities – specific powers include

- Denying Treaty Benefits
- Disregarding, combining, recharacterizing any step or the whole arrangement
- Treating the arrangement as if it had not been entered into
- Disregarding accommodating parties
- Deeming connected persons to be one and the same for the purpose of determining tax treatment of any amount
- Reallocating income, expenditure, deduction, reliefs or rebates
- Re-determining place of residence/location/situs of parties or assets
- Looking through any arrangement by disregarding corporate structures
- Recharacterizing debt as equity or vice-versa and capital receipt as revenue receipt

GAAR – Exclusions

- In case where the tax benefit in India, in aggregate, to all the parties to the arrangement, during the year does not exceed INR 3 crore
- GAAR not applicable to Foreign Portfolio Investors (FPIs), who have not taken treaty benefits
- GAAR not applicable to non-residents in respect of investments made in offshore derivative instruments in an FPI (P-Notes)
- GAAR not applicable in respect of income from transfer of investments made before 1 April 2017

Interaction between GAAR and tax treaties

Treaty override (1/3)

- **Section 90(2) of IT Act**

  Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

- **Section 90(2A) of the IT Act**

  Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him.

GAAR provisions have an overriding effect over treaty provisions

Treaty override (2/3)

- **Whether tax treaty, being a bilateral agreement, can be unilaterally overridden by a country through its domestic laws?**
  - ***Conflict with Article 26 of Vienna Convention*** which lays down the principles of *pacta sunt servanda,* i.e., every treaty in force is binding upon the parties to it and must be performed by them in good faith
  - Para 77 of ***Commentary on Article 1 of OECD Model Convention 2017***, *inter alia*, provides that there exists no conflict between the provisions of tax treaty and domestic GAAR if the provisions of domestic GAAR are formulated in line with the principle of PPT

Treaty override (3/3)

Some tax treaties [for instance, with Singapore, Malta, Indonesia, Luxembourg, Malaysia, Colombia, Spain (though recent Protocol)] specifically provide for application of domestic anti-abuse provisions over the beneficial provisions of tax treaties

- **Article 28A of India-Singapore DTAA**

  This Agreement shall not prevent a Contracting State from applying its domestic law and measures concerning the prevention of tax avoidance or tax evasion.

- **Article 28B(1) of India-Spain DTAA**

  The Contracting States declare that their domestic rules and procedures with respect to the abuses of law (including tax treaties) may be applied to the treatment of such abuses.

Anti-avoidance measures under tax treaties

Anti-avoidance measures under tax treaties

Title and Preamble	LOB	PPT	Beneficial Ownership
A clear statement/ preamble in treaties that countries intend to avoid creating opportunities for non-taxation / tax avoidance / treaty shopping	Specific anti-abuse rule (simplified or detailed) in the form of a comprehensive Limitation of Benefit (LOB) Article	If one of the principal purposes of the arrangements is to obtain treaty benefits, benefits would be denied	Even prior to MLI, treaties have provided for benefit of lower tax rate for dividend, interest, royalty and FTS only if recipient is a beneficial owner of such income

Interplay between GAAR and LOB

Forms of LOB provisions under tax treaties

- Condition of 'beneficial ownership' to be satisfied by income recipient for certain categories of income such as dividend, interest, etc.
- 'Subject to tax' condition instead of 'liable to tax' condition vis-à-vis definition of tax resident
- Specific condition to be fulfilled vis-à-vis exemption from category of income. E.g. capital gains exemption condition under India-Singapore tax treaties
- Specific article on LOB dealing with conduit entities or treaty shopping or entities attempting to claim double non-taxation

- **CBDT Circular No. 7 of 2017 – Question 2**

Question no. 2: *Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?*

Answer: *Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is* <u>*sufficiently addressed by LOB*</u> *in the treaty, there shall not be an occasion to invoke GAAR*

Interplay between GAAR and PPT under MLI (1/6)

Article 7 of Multilateral Instrument (MLI) – Principal Purpose Test

Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit ***was one of the principal purposes*** *of any arrangement or transaction that resulted directly or indirectly in that benefit,* **('reasonable purpose test') – Question of fact**

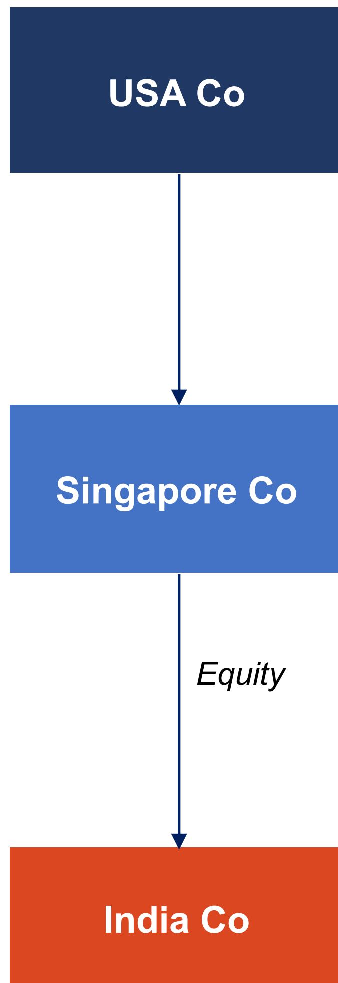
Unless

it is established that granting that benefit in these circumstances would be ***in accordance with the object and purpose*** *of the relevant provisions of the Covered Tax Agreement."* **('object and purpose test') – Question of law**

Interplay between GAAR and PPT under MLI (2/6)

Particulars	Domestic GAAR	PPT
Applicability	• Main purpose is tax benefit • One of the tainted element tests is satisfied	• One of the principal purpose is tax benefit • Not in accordance with objects and purpose of treaty
Consequences	• Recharacterization of transaction, reallocation of income, denial of treaty benefits, etc.	• Denial of treaty benefits
Onus	• Primary onus is on tax authority	• Primary onus is on tax authority and rebuttal assumption for carve out
Administrative safeguards	• Approving Panel	• To be determined by respective countries
***Deminimis* threshold**	• Yes	• No
Grandfathering of existing investments	• Yes	• No

Interplay between GAAR and PPT under MLI (3/6)



- Singapore Co ('SG Co') had invested in equity shares of India Co ('I Co') before 1 April 2017
- Article 13(4A) of India-Singapore DTAA
- India to have right to tax gains arising from alienation of shares of I Co acquired by SG Co on or after 1 April 2017
  - Gains from alienation of shares acquired on or before 31 March 2017 grandfathered
- Rule 10U(1)(d) of IT Rules
- GAAR not to apply in respect of income from transfer of investment made before 1 April 2017
- SG Co transfers some shares of I Co in April 2019
- SG Co is proposing to transfer balance shares of I Co in September 2020

Interplay between GAAR and PPT under MLI (4/6)

Shares of I Co transferred by SG Co in April 2019

Applicability of GAAR

- Grandfathering under Rule 10U(1)(d) for gains from transfer of investment made before 1 April 2017
- Shares of I Co acquired by SG Co before 1 April 2017
- GAAR should not apply

Applicability of PPT under MLI

- MLI provisions (including those relating to PPT) to apply to India-Singapore DTAA w.e.f. 1 April 2020
- PPT should not apply to transfer of shares of I Co by SG Co undertaken in April 2019

Interplay between GAAR and PPT under MLI (5/6)

Shares of I Co proposed to be transferred by SG Co in September 2020

Applicability of GAAR

- Grandfathering under Rule 10U(1)(d) for gains from transfer of investment made before 1 April 2017
- Shares of I Co acquired by SG Co before 1 April 2017
- GAAR should not apply

Applicability of PPT under MLI

- MLI provisions (including those relating to PPT) to apply to India-Singapore DTAA w.e.f. 1 April 2020
- **View 1:** PPT not applicable since DTAA contains specific provisions for grandfathering past investments
- **View 2:** PPT is a non-obstante provision and is applicable to entire DTAA (even to grandfathering provisions)
- **View 3:** While PPT applies to grandfathering provisions, availing benefit under such provisions is in accordance with object and purpose of the DTAA

Interplay between GAAR and PPT under MLI (6/6)

- **Assuming PPT is triggered for shares proposed to be sold in September 2020, can SG Co seek to cover itself under domestic GAAR, rather than treaty GAAR (PPT), on the contention that provisions of GAAR are more beneficial?**
- **Whether as per Article 28A of India-Singapore treaty, arrangement needs to be evaluated only under GAAR?**

- **Section 90(2) of the Act**

  "Where the Central Government has entered into an agreement with the Government of any country outside India………………under sub-section (1) for granting relief of tax, ………………, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee"

- **Section 90(2A) of the Act**

  "Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him."

- **Article 28A of India-Singapore treaty:**

  "This Agreement shall not prevent a Contracting State from applying its domestic law and measures concerning the prevention of tax avoidance or tax evasion."

GAAR and Treaty Shopping (1/2)

Treaty Shopping –improper use of double tax avoidance convention

Under treaty shopping, a person resident of one country (Country A) acts through a legal entity created in another country (Country B) essentially to obtain treaty benefits which Country B has with a third country, which would otherwise not be available directly

SC in Azadi Bachao Andolan

- Developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them
- Loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy
- The Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper.

SC in Vodafone International Holdings BV

- Legal doctrines like "Limitation of Benefits" and "look through" are matters of policy
- 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

GAAR and Treaty Shopping (2/2)

Invoking GAAR in case of treaty shopping

Main Purpose Test

- Main purpose is to *avail benefit of favourable tax treaty*

Tainted Element Test

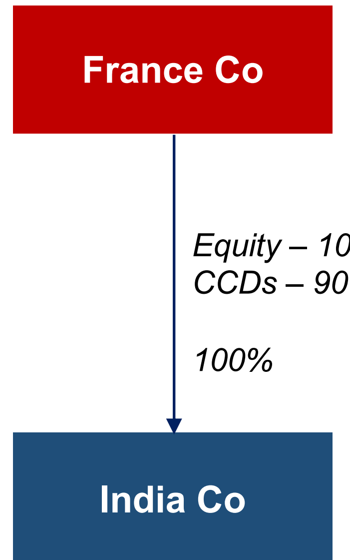
- Results in the *misuse, or abuse, of the provisions of the Act* viz. section 90(2) which provides that assessee can apply treaty provisions if the same are more beneficial than the Act
- *Lacks commercial substance* or deems to lack commercial substance u/s 97
  - √ Involves *location* of an asset or of a transaction or of place of residence of any party which is *without any substantial commercial purpose* other than obtaining a tax benefit
  - √ *No significant effect upon 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

Possible consequences where treaty shopping is regarded as IAA

- *Denial* of tax treaty benefit
- *Disregarding* the arrangement / treating it as if it had not been entered into
- Treating the place of residence of any party to arrangement or situs of an asset or of a transaction at a *place other than the place of residence*, location of the asset or location of the transaction as provided under the arrangement
- *Looking through* any arrangement by disregarding any corporate structure

Applicability of GAAR to some international structures / transactions

Debt Equity Mix – Inbound investment (1/4)



- France Co has infused majority amount (90) as CCDs and nominal amount (10) as equity in India Co (I Co)
- This will enable I Co to avail deduction of interest expense on CCDs
- Interest paid by I Co to France Co is at arm's length and within the limit u/s 94B

Debt Equity Mix – Inbound investment (2/4)

Revenue's contentions

- Main purpose of investing majority funds as CCDs is to avail deduction of interest expenditure for I Co
- France Co is the parent company of I Co – no significant change in risk borne, whether investment is as equity or as CCDs
- Section 97(1)(d) – Arrangement lacks commercial substance as it does not have a significant effect upon the business risks or net cash flows of France Co
- Applicability of transfer pricing and section 94B (SAAR) cannot preclude tax authorities from invoking GAAR
- SAAR may not address all situations of abuse – GAAR and SAAR can co-exist (Question no. 1 of CBDT Circular no. 7 of 2017)

I Co's contentions

- GAAR will not interplay with the right of taxpayer to select or choose method of implementing a transaction (Question no. 3 of CBDT Circular no. 7 of 2017)
- CCDs ensure regular cash flows in form of interest and at the same time retain upside in equity
- Dividend on shares payable only in case of availability of profits at I Co level
- No applicability of GAAR considering SAAR provisions (transfer pricing & section 94B)
- CCDs can facilitate divestment in favour of potential buyer who has a preference for debt investment

Whether assessee needs to demonstrate the 'purpose test' even in case where he has a choice available to undertake the transaction in a different manner?

Debt Equity Mix – Inbound investment (3/4)

Consequences where investment in CCDs is held to be an impermissible avoidance arrangement

- Section 98(2) – Recharacterization of debt into equity
- Where CCDs are recharacterized as equity –
  - Interest on CCDs to be regarded as dividend and not to be allowed as deductible expenditure for I Co
- As per India-France DTAA –
  - Interest taxable @ 10%
  - Dividend taxable @ 5% (by virtue of MFN clause)

Whether impact of recharacterization of debt as equity to be considered only for I Co?

Or whether impact of such recharacterization to be also considered and given effect to for France Co (even where it results in a beneficial tax treatment for France Co) – Please refer next slide

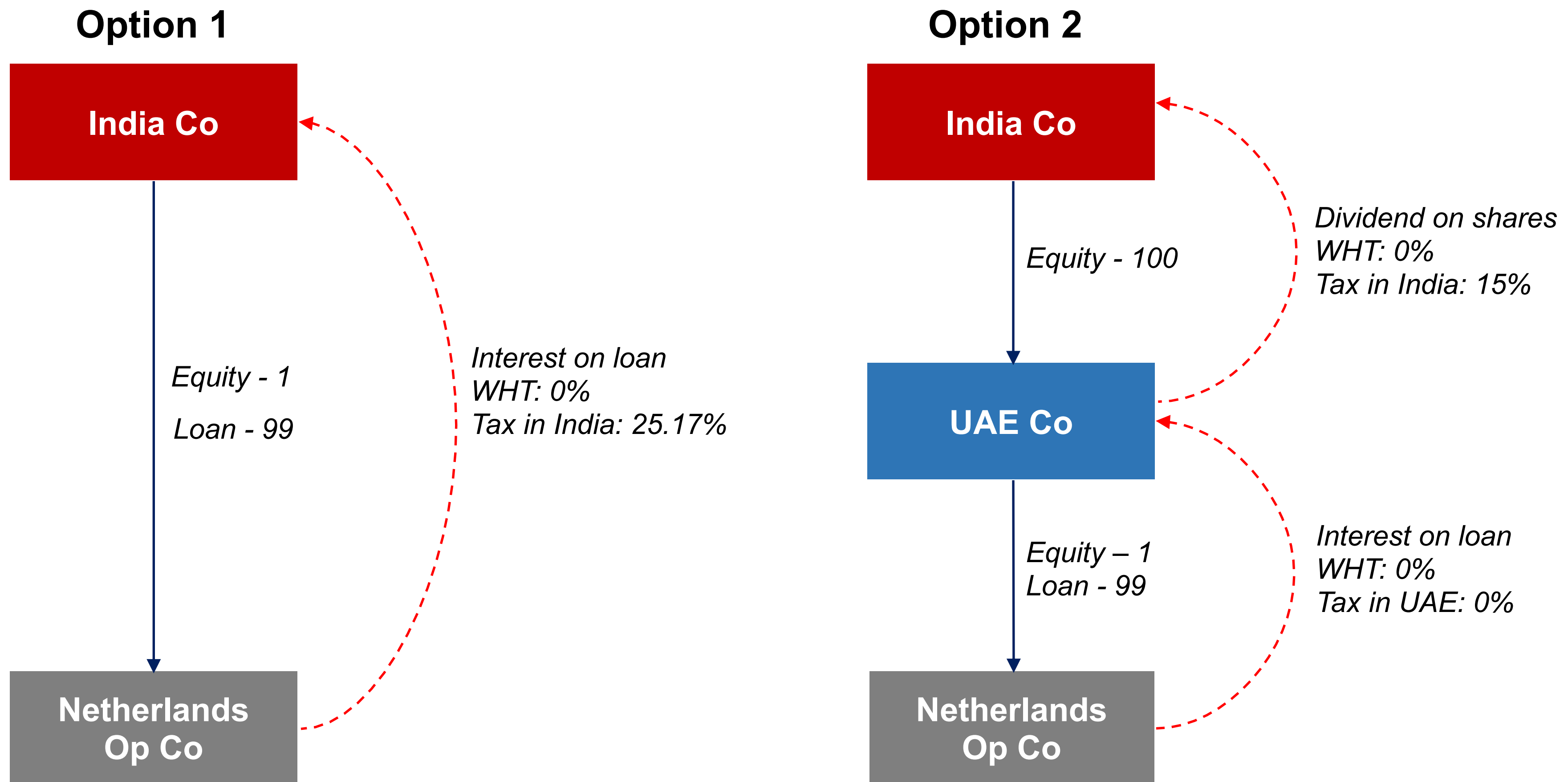
Debt Equity Mix – Inbound investment (4/4)

Whether impact of recharacterization of debt as equity to be also considered and given effect to for France Co (even where it results in a beneficial tax treatment for France Co)?

- Where CCDs are recharacterized as equity for France Co, interest income to be regarded as dividend
- Dividend taxable under India-France DTAA @ 5% (considering MFN clause)
- Whether such recharacterization to be done for France Co also?
- Question no. 13 of CBDT Circular no. 7 of 2017 –

Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.

Debt Equity Mix and interposing IHC – Outbound investment (1/2)



Option 2 is more tax efficient as compared to Option 1
Where rationale for setting up UAE Co cannot be substantiated, invocation of GAAR by tax authorities likely which can potentially result in recharacterization of equity infused in UAE Co as loan thereby taxing dividend income from UAE Co as interest income

Debt Equity Mix and interposing IHC – Outbound investment (2/2)

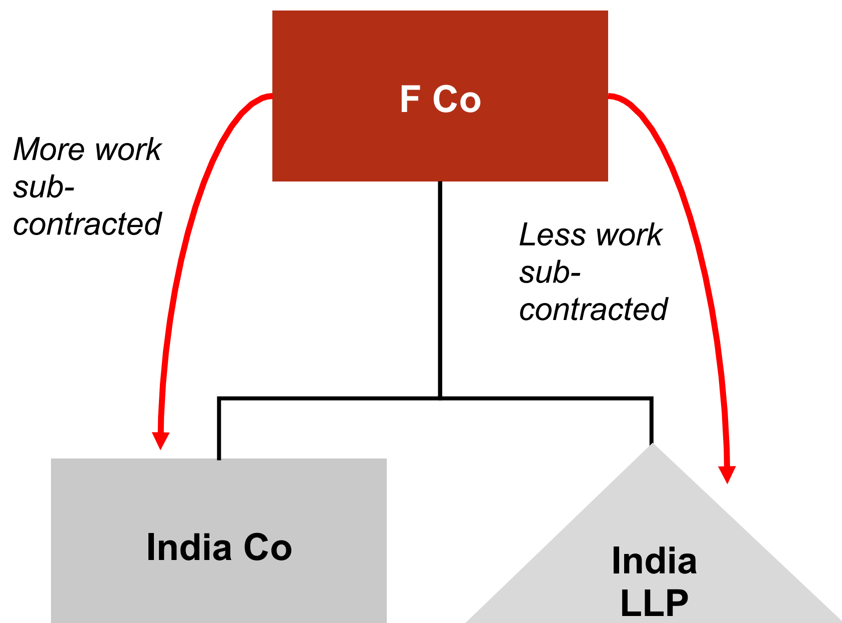
Demonstrating commercial need for IHC

- A single entity holding for outbound operations
- Ease of raising funds for further investment
- Ring fencing parent company from liabilities of operating subsidiaries
- Ease in overseas listing

SC in Vodafone International Holdings BV [2012]

- Special Purpose Vehicles (SPVs) and Holding Companies have a place in legal structures in India, be it in company law, takeover code under SEBI or even under the Income-tax law
- In a case where the Revenue finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such inter-positioning of that entity. However, this has to be done at the threshold
- The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the "look at" test to ascertain its true legal nature

Choice Principle: Company vs LLP

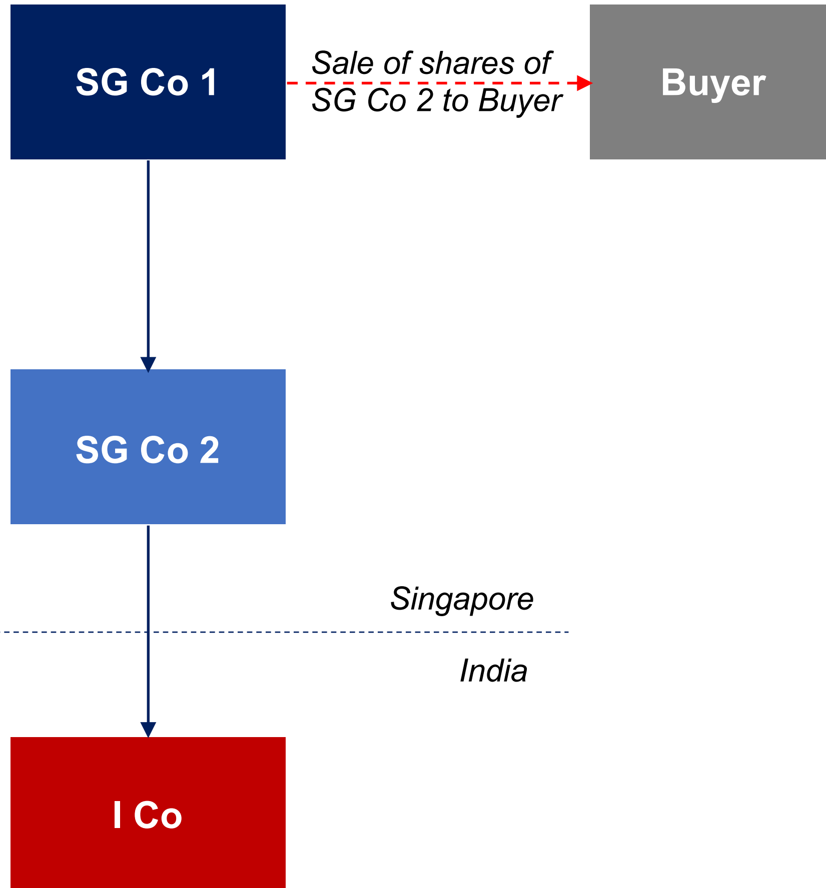


- Company model more attractive for F Co as compared to LLP considering –
  - Lower tax rate of 25.17% vs 34.94% for LLPs
  - Abolition of DDT
  - Low withholding tax @ 5% on dividend as per applicable DTAA
- F Co decides to sub-contract more work to India Co instead of Indian LLP

GAAR Impact ?

- Can a business decision on whom to sub-contract work, be questioned under GAAR?
- Since decisions are solely made by F Co., are India Co. and the LLP parties to any 'arrangement'?
- Can the India Co be disregarded?
- How can income be allocated between India Co. and the LLP?

Indirect Transfer



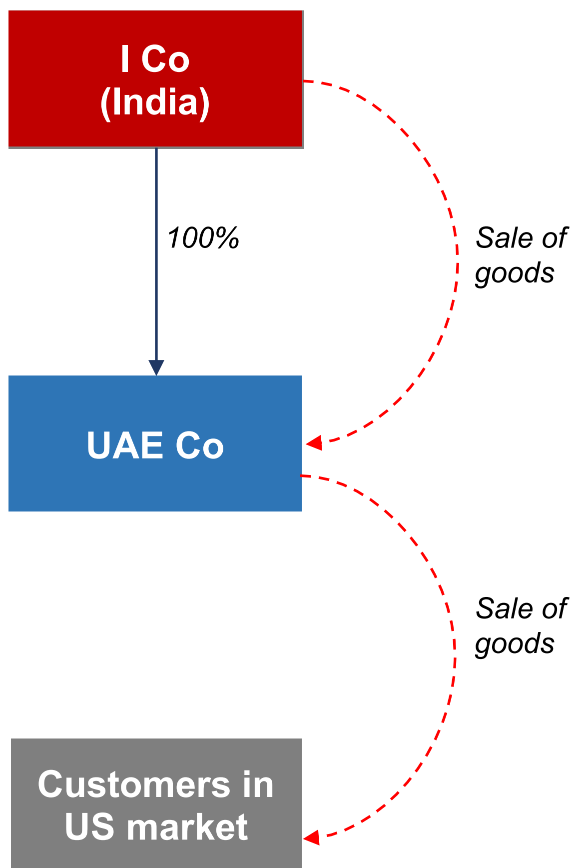
- Shares of SG Co 2 derive their value substantially from assets located in India i.e. shares of I Co
- Transfer of shares of SG Co 2 by SG Co 1 taxable in India under section 9(1)(i) of the Act
- Such gains on indirect transfer still outside the purview of taxation in India considering provisions of India-Singapore DTAA*

GAAR Impact ?

- Can double layer holding be said to be lacking commercial substance?
- Can shareholding of SG Co 1 in SG Co 2 be disregarded and looked through as direct holding in I Co?
- Need for robust documentation and strong commercial rationale pertinent for treaty benefit

** Treaty benefit has been allowed in indirect transfer in *Sanofi Pasteur Holding SA [2013] 30 taxmann.com 222 (Andra Pradesh HC), Sofina SA [2020] 116 taxmann.com 706 (Mumbai ITAT), GEA Refrigeration Technologies GmbH, In re [2018] 89 taxmann.com 220 (AAR). However, recently AAR in Tiger Global International II Holdings (AAR/04/2019) denied such treaty benefit*

Trading Company



- I Co is proposing to start selling goods in international market
- For this purpose, I Co plans to sell goods to overseas customers through its wholly owned subsidiary in UAE
- UAE Co to provide marketing and distribution services
- Suppose I Co is able to justify price of goods sold to UAE Co at arm's length in compliance with transfer pricing ('TP') provisions

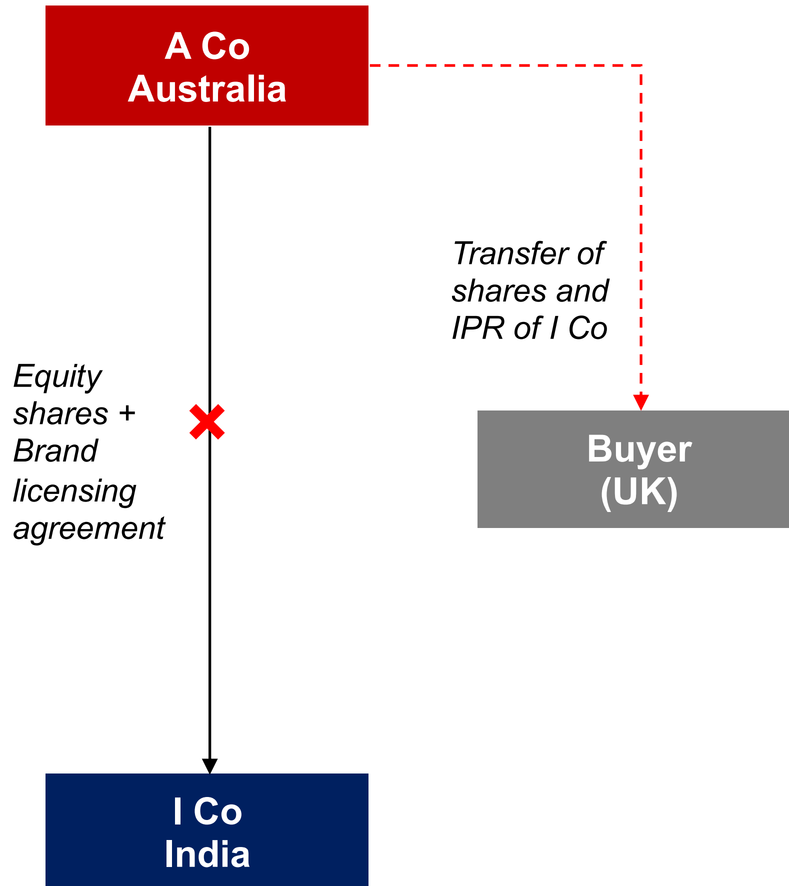
GAAR Impact - ?

- Whether compliance with TP provisions can preclude AO from applying GAAR provisions?
- Application of transfer pricing provisions limited to computation of ALP
- Under GAAR – Revenue can disregard setting up UAE subsidiary (such power not available under TP provisions)
- Where POEM test is satisfied – whether GAAR can still be invoked?
- Thrust under GAAR on purpose test – need for justifying commercial rationale for setting up UAE subsidiary?

Invocation of GAAR v. Triggering of POEM provisions

Applicability of GAAR where TP provisions are held to be complied with – ?

Transfer of IPR (1/2)



- A Co is the owner of brand
- A Co has granted an exclusive license to I Co to sell its products and exclusive right to use its trademarks with the territory of India ('IPR')
- Subsequently, A Co enters into an agreement with UK Buyer for transfer of shares and IPR of I Co
- As a pre-condition to transfer, brand license agreement entered into between A Co and I Co was terminated

Delhi HC in Cub Pty Ltd v. UOI [2016]

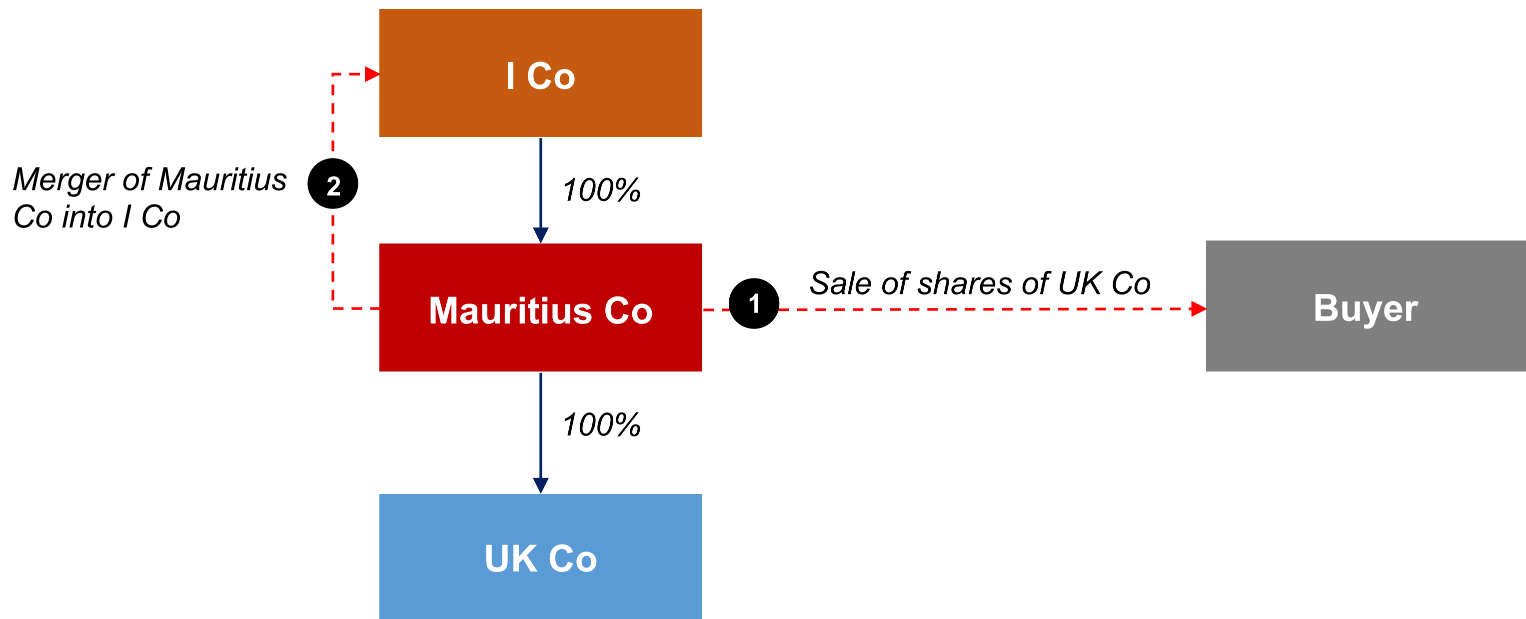
- Unlike provision for taxability of transfer of shares of overseas entity deriving substantial value from assets in India, no specific provision for IPR
- Principle of *mobilia sequuntur personam* to apply
  - Personal property held by a person is governed by the same law that governs that person
- Situs of IPR to be where the situs of owner of intangible asset is situated i.e. Australia in this case
- No tax liability in India for transfer of IPR

Transfer of IPR (2/2)

GAAR Impact

- Transfer of IPR legally owned outside India but exploited commercially in India
- Testing the arrangement under GAAR considering the following parameters –
  - Whether the main purpose of 'step' involving termination of brand licensing agreement is to avoid tax liability in India?
  - Whether the arrangement results in abuse of provisions of the Act (section 9)?
  - Whether the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part?
- Disregarding of legal ownership of IPR to consider situs of IPR as the place where IPR is exploited economically under GAAR

Investment through IHC



If I Co had invested in UK Co directly –

- Direct sale of shares of UK Co by I Co would have resulted in long-term capital gains tax @ 23.3%

In case of investment through Mauritius Co

- Sale of shares of UK Co by Mauritius Co and subsequent merger of Mauritius Co into I Co not taxable in India

In above case, investment through Mauritius Co facilitates tax efficient exit – can GAAR be invoked even though there is a considerable time gap between original investment in Mauritius Co and exit?

Section 97(4) of IT Act provides that the period or time for which the arrangement exists may be relevant but shall not be sufficient for determining whether an arrangement lacks commercial substance or not

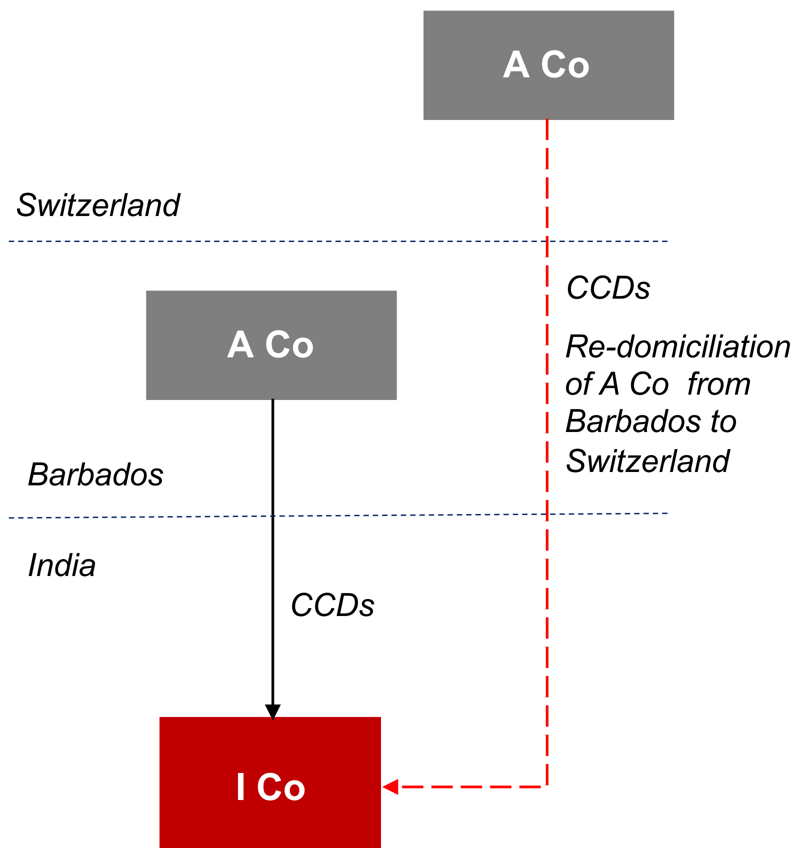
Computation of threshold of INR 3 crores

- Question no. 14 of CBDT circular no. 7 of 2017

Question: *Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in hands of one or few parties selectively).*

Answer: *The application of tax laws is jurisdiction specific and hence what can be seen and examined is the 'Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs.3 crores cannot be read in respect of a single taxpayer only.*

Re-domiciliation (1/2)



- Re-domiciliation is a process by which a company moves its 'domicile' (or place of incorporation) from one jurisdiction to another
- It enables companies to avoid liquidating the existing company and transfer the jurisdiction
- Laws of existing as well as target jurisdiction should permit re- domiciliation
- Suppose A Co re-domiciles from Barbados to Switzerland
- Before re-domiciliation: WHT on interest on CCDs – 40% (no DTAA between India and Barbados)
- After re-domiciliation: WHT on interest on CCDs – 10% as per India-Switzerland DTAA

Can Revenue invoke GAAR where such re-domiciliation also results in tax benefit?

Assessee to substantiate commercial reasons for re-domiciliation to a particular jurisdiction

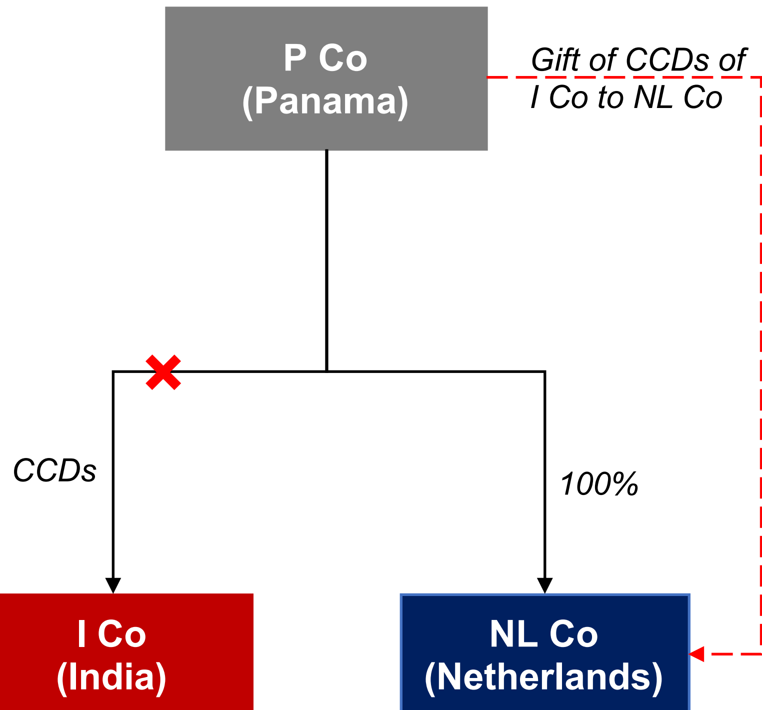
Re-domiciliation (2/2)

Commercial factors for selection of particular jurisdiction

Reliable legal system	Business friendly environment	Political stability
Membership of a regional group	Sophisticated banking industry	Comprehensive double taxation treaty network

Important to demonstrate that decision to invest through a particular jurisdiction is driven by commercial factors and not primarily motivated by tax benefit

Grandfathering under GAAR (1/3)



- P Co invested in CCDs of I Co in April 2015
- The terms of CCDs provided for payment of interest from April 2017 onwards
- P Co gifts CCDs of I Co to NL Co before 1 April 2017
  - NL Co is a company incorporated in Netherlands and is wholly owned by P Co
- NL Co proposes to sell CCDs of I Co
- Gift of CCDs
  - No capital gains in India
  - No tax in the hands of NL Co in India – Provisions of section 56(2)(viia) as applicable at that point time did not apply to CCDs
- Interest on CCDs
  - Tax on payment of interest by I Co to P Co: 20% (if money is borrowed in foreign currency) / 40%
  - Tax on payment of interest by I Co to NL Co @10%

Grandfathering under GAAR (2/3)

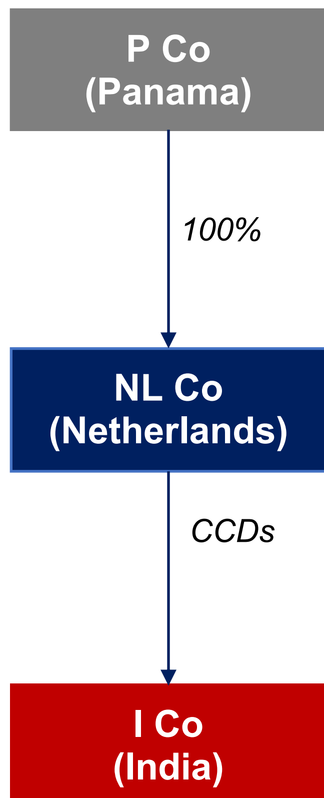
Gift of CCDs

- CCD holding through NL Co instead of P Co beneficial from capital gains perspective
- CCDs were acquired by P Co before 1 April 2017
- Whether GAAR provisions can apply to such arrangement?
- Rule 10U(1)(d) of IT Rules – 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 1 April 2017*** by such person
- Grandfathering applicable to 'investment' and not 'acquisition'
- Acquisition by way of gift of shares may not be regarded as 'investment' and hence grandfathering benefit may be denied

Interest on CCDs

- Grandfathering benefit available only in case of income from transfer of investments made before 1 April 2017 and not on recurring income on investments like interest

Grandfathering under GAAR (3/3)



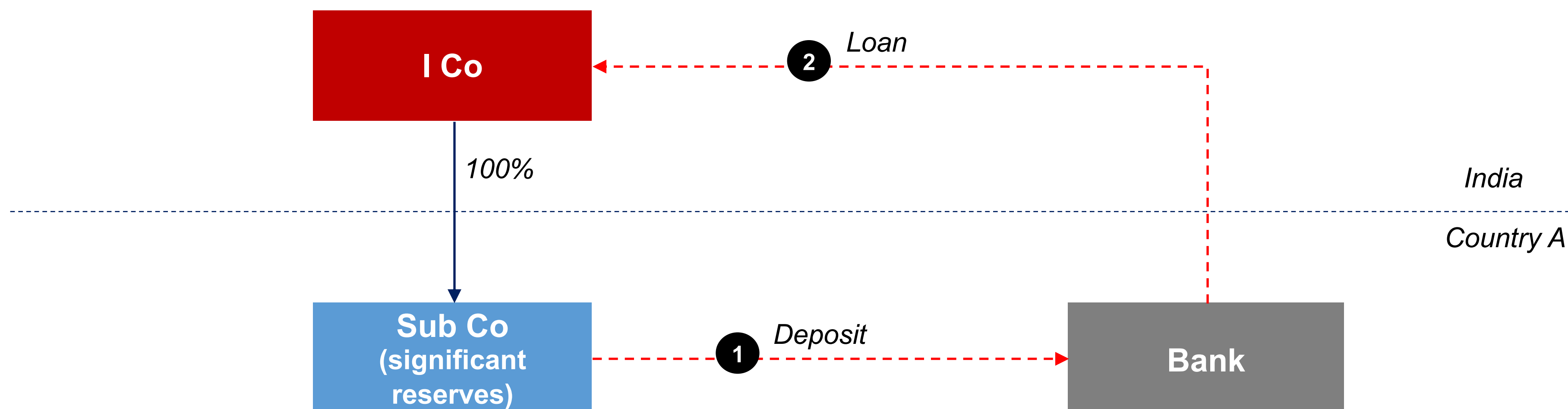
Applicability of judicial GAAR

- Suppose original investment in CCDs of I Co itself was made by NL Co (instead of P Co)
- Investment made in April 2015
- Such investment should be eligible for grandfathering benefit under Rule 10U(1)(d) of IT Rules
- Whether judicial GAAR can still be applied by tax authorities?

Grandfathering for shares received upon conversion of CCDs

- Assuming NL Co converts CCDs into equity shares after 1 April 2017
- NL Co intends to sell such equity shares received upon conversion of CCDs to a non-resident buyer
- As per India-Netherlands DTAA, such capital gains on sale of shares not taxable in India
- Whether such gains also eligible for grandfathering benefit under Rule 10U(1)(d) even though equity shares have been received after 1 April 2017?
  - *Question no. 5 of CBDT Circular no. 7 of 2017 –*
    - *Grandfathering under Rule 10U(1)(d) will be available to investments made before 1 April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments*

Accommodating Party (1/2)



- I Co proposes to borrow funds from Sub Co – this would however result in tax liability for I Co u/s 2(2)(e)
- Sub Co makes a term deposit with a Bank. The Bank based on this security provides a back to back loan to I Co. Treaty between India and Country A provides that interest paid by a resident of one country to a bank which is a resident of another country shall not be taxable in first mentioned country
- This can be treated as an arrangement whose main purpose is to bring money out of reserves in Sub Co to India without payment of due taxes
- The arrangement disguises the source of funds by routing it through the Bank

Can the Bank be treated as an accommodating party (discussed in next slide) and consequently can the arrangement be deemed to lack commercial substance?

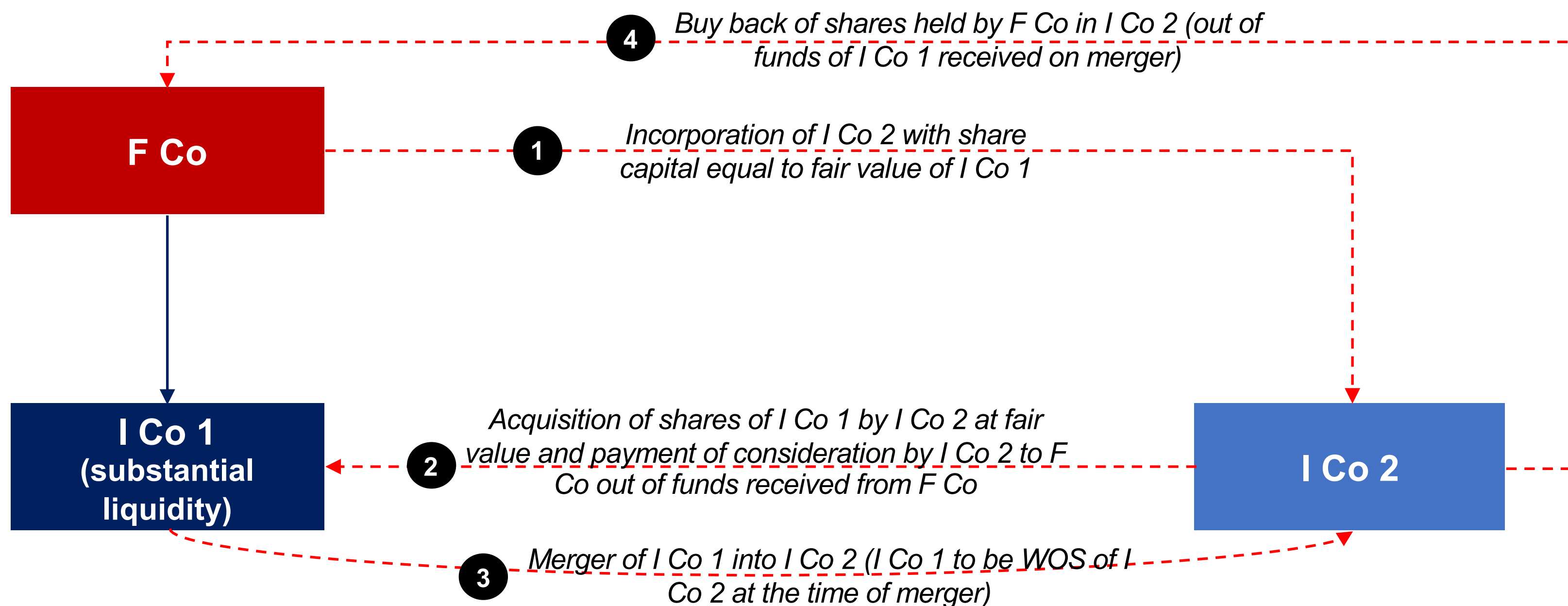
If yes, then the loan amount would be treated as dividend income received from Sub Co to the extent reserves are available in Sub Co; and no expense by way of interest on loan paid to Bank would be allowed to I Co

Accommodating Party (2/2)

Accommodating Party – Section 97(3) of the IT Act

- A party to an arrangement shall be an accommodating party –
  - if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part
  - is to obtain, directly or indirectly, a tax benefit for the assessee
  - whether or not the party is a connected person in relation to any party to the arrangement

Round Trip Financing (1/2)



Objective: To extract cash from I Co 1 without significant tax cost

- No capital gains tax for F Co on transfer of shares of I Co 1 to I Co 2 at fair value – not regarded as transfer u/s 47(iv)
- Infusion of share capital in I Co 2 by F Co at high premium – section 56(2)(viib) not applicable in case of receipt of consideration for issue of shares from non-resident
- Due to high amount received at the time of issue of shares by I Co 2, no significant buy-back tax liability should arise for I Co 2
- Assumption: Buy-back of shares by I Co 2 to be in compliance with the provisions of the Companies Act, 2013
- Applicability of GAAR provisions in the instant case - ?

Round Trip Financing (2/2)

Contentions by Revenue

- Main object of entire arrangement is to repatriate funds to F Co by reducing tax liability in India
- The arrangement lacks commercial substance
  - It involves round trip financing
- Entire arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes

Round trip financing defined u/s 97 of the IT Act as under –

- Round trip financing includes any arrangement in which, through a series of transactions—

  (a) funds are transferred among the parties to the arrangement; and

  (b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit,

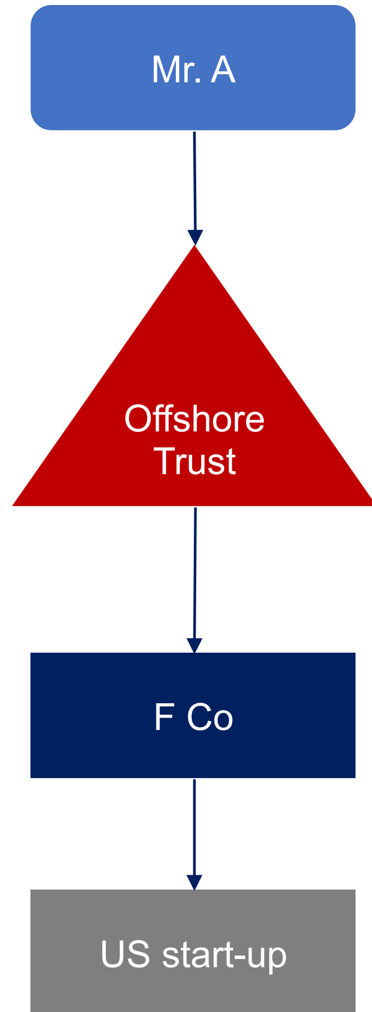
  without having any regard to—

  (A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

  (B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

  (C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Offshore Trust (1/2)



- Mr. A, an Indian citizen, was employed with a Dubai company for last 7 years
- He intends to re-locate to India in FY 2021-22
- Prior to re-locating to India, he settles a trust in a tax efficient jurisdiction with funds held in his Dubai bank account
- The trustee of the trust is an independent trustee company and beneficiaries of the trust comprise of Mr. A's spouse and his son
- The trust incorporates a company ('F Co') in a tax efficient jurisdiction
- Mr. A gifts the shares of a US start-up to F Co in FY 2020-21
- Investment in the US start-up was made out of salary income received by Mr. A while working with Dubai company
- F Co sells the shares of US start-up to an investor in FY 2021-22
- Had Mr. A continued to hold shares of US start-up, gains on sale of such shares would have been taxable in India
- To evaluate implications under GAAR

Offshore Trust (2/2)

Contentions of Revenue

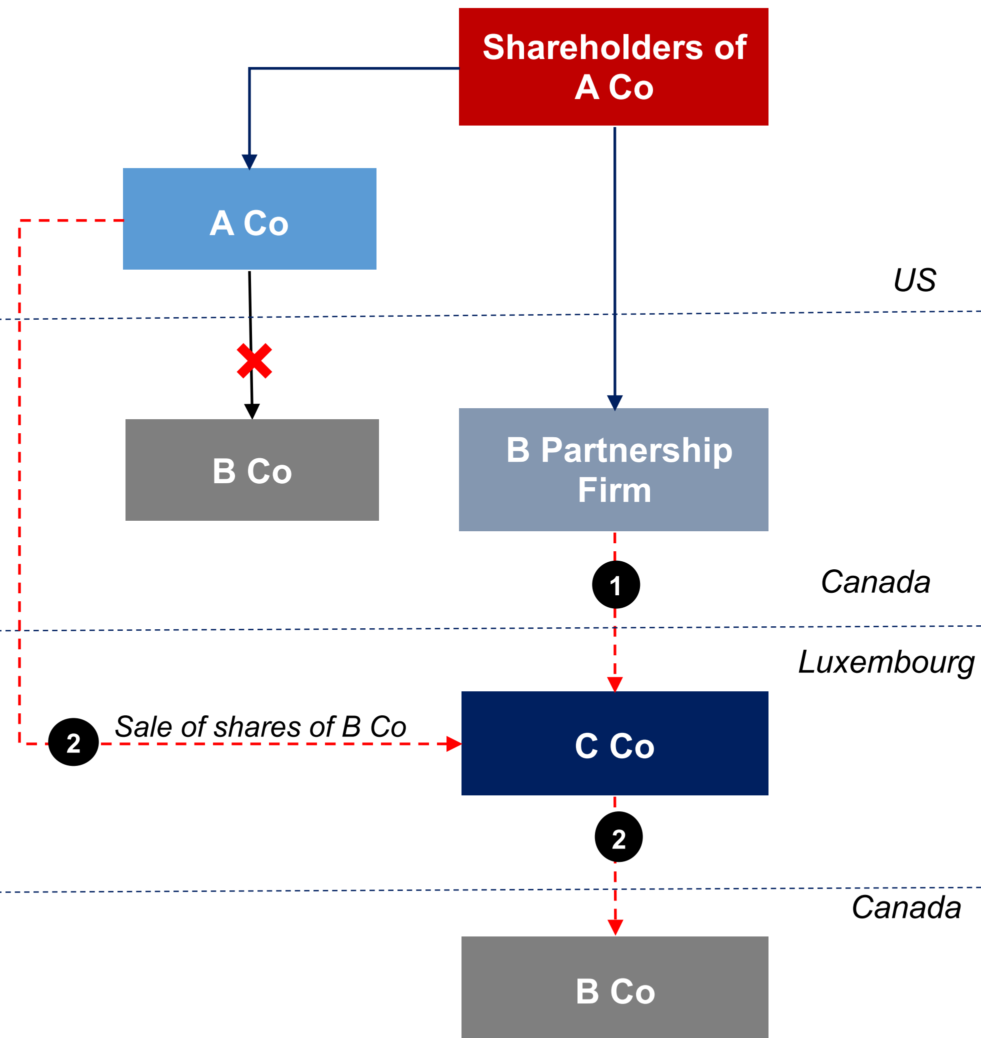
- Main purpose of setting up overseas structure and gifting shares of US start-up to F Co is to avoid tax liability in India
- No rationale for holding shares through F Co – shares could have been held directly or through trust
- Section 97(1)(b) – arrangement involves a transaction which is conducted through one or more persons and disguises the ownership of funds which is the subject matter of such transaction

Contentions of Assessee

- Main purpose of setting up the structure is to facilitate succession planning and asset protection and not to avoid tax
- F Co set up as a holding entity to house offshore investments
- Trust to be managed by an independent trustee

International Jurisprudence on GAAR

Crown v. Alta Energy Luxembourg S.A.R.L 2020 FCA 43 – Canadian Federal Court (1/3)



Facts

- B Co was wholly owned subsidiary of A Co
- A restructuring exercise was undertaken, as a part of which
  - C Co was formed under the laws of Luxembourg
  - Shares of C Co were held by 'B Partnership Firm' in Canada. Shareholders of A Co were partners in B Partnership Firm
  - Shares of B Co were transferred by A Co to C Co
  - At the time of transfer of shares of B Co, fair market value of shares of B Co was equal to adjusted cost base of these shares and hence no capital gains arose
- After a year, C Co sold the shares of B Co earning substantial gains and claimed exemption in respect of the same under Canada-Luxembourg tax treaty

Crown v. Alta Energy Luxembourg S.A.R.L 2020 FCA 43 – Canadian Federal Court (2/3)

Relevant extract of Article 13 of Canada-Luxembourg tax treaty

"(4) Gains derived by a resident of a Contracting State from the alienation of:

- *a. shares (other than shares listed on an approved stock exchange in the other Contracting State) forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State; or*
- *b. an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State,*

may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company.

(5) Gains from the alienation of any property, other than that referred to in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator is a resident."

Crown v. Alta Energy Luxembourg S.A.R.L 2020 FCA 43 – Canadian Federal Court (3/3)

Assessee's Contention

- Gains were covered by treaty and GAAR did not apply because there was no abuse of the provisions of treaty

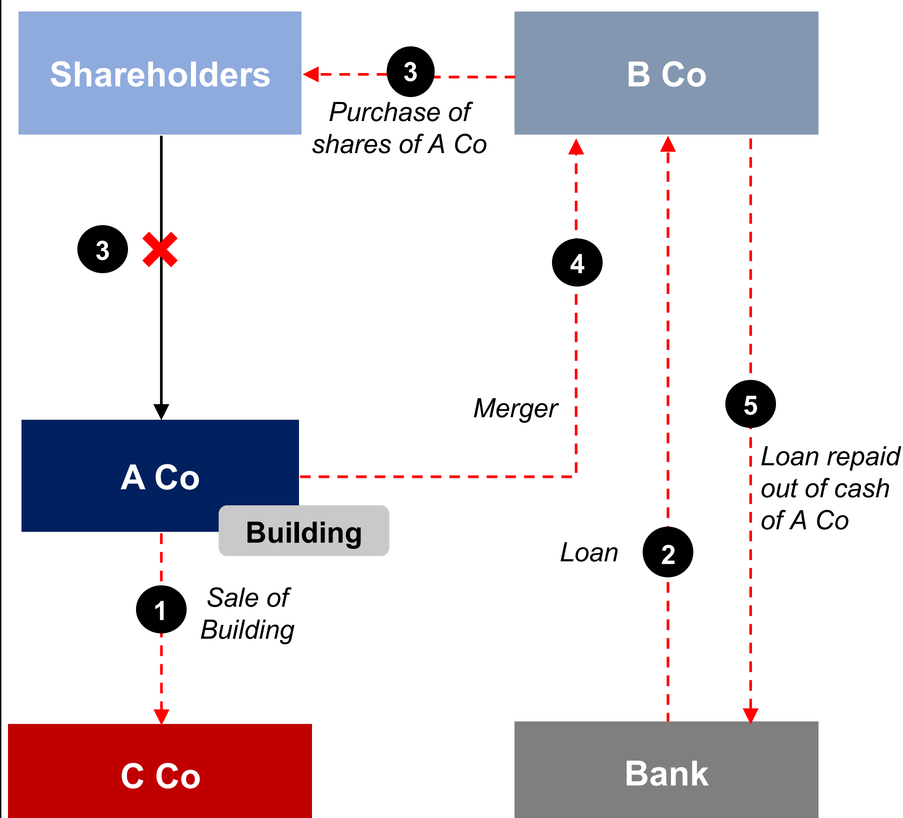
Observations of Federal Court

- If there is no abuse of treaty, there would be no abuse of the Act
- Two step process –
  - The first step of the process is to identify the object, spirit, and purpose of the relevant provisions the treaty
  - The second step is to determine whether the transactions resulted in an abuse of these provisions.
- The object, spirit and purpose of the treaty is that a person will qualify for the exemption to gains arising on the disposition of certain shares, if:
  - that person is a resident of Luxembourg for the purposes of the Luxembourg treaty, and
  - the value of the shares is not derived principally from immovable property (other than the property in which the business of that corporation is carried on) situated in Canada
- As the provisions operated as they were intended to operate, there was no abuse and GAAR does not apply

Relevance of this decision in case of 'PPT regime'?
Amended Preamble of Covered Tax Agreements – *"….without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this agreements for the indirect benefit of resident jurisdiction)…."*

Under Indian GAAR – denial of treaty benefit is one of the consequences of impermissible avoidance arrangement

McNichol v. The Queen (Canada Court) [1997] 2 CTC 2088



Facts

- A Co sold building owed by it (the only asset) to C Co
- After sale, the only asset held by A Co was cash
- Shareholders sold all the shares of A Co to B Co – for this, funding was availed by B Co from Bank
- Post acquisition of shares, A Co was merged into B Co
- B Co then repaid loan with cash available in A Co
- Distribution of dividend would have been taxable for shareholders of A Co
- For gains earned on sale of shares of A Co – shareholders can avail 'lifetime capital gains exemption' to avoid capital gains tax

Court Ruling on applicability of GAAR

- Two tests
  - Is the transaction an "Avoidance transaction"?
  - Does the transaction result in misuse or abuse?
- Sale of shares of an inactive company (A Co) was an avoidance transaction lacking a bona fide purpose
- Sale was intended to trigger capital gain eligible for the exemption. An abuse of the provisions of the Act

Concluding Remarks

Concluding Remarks

- ✓ Increased focus on commercial purpose and substance
- ✓ Robust documentation to demonstrate the bona fides of transactions imperative in GAAR era
- ✓ Overlap between GAAR and SAAR
- ✓ Interplay between GAAR and PPT in international taxation
- ✓ Review of transactions cost – litigation cost to be factored ?
- ✓ Advance Rulings for GAAR applicability on crucial transactions ?
- ✓ Enforcement of GAAR by tax authorities – judicious application of GAAR instead of indiscriminate application of the provisions

Q&A

Thank You