WIRC of ICAI

Anti Avoidance Tools - Understanding GAAR and Interplay with PPT under MLI

CA Pinakin Desai

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GAAR

Judicial GAAR (JAAR) – Precursor to GAAR

- Tax planning is legitimate provided it is within the framework of law
- A tax-saving motive does not justify the taxing authorities or the courts to nullify or disregard otherwise proper, valid and bona fide transaction
- However, law does not protect transactions that are a colourable device or sham
- **Vodafone International Holdings BV [2012] 341 ITR 1 (SC):**

> *"DTAA and Circular No. 789 dated 13.4.2000, in our view, would not preclude the Income Tax Department from denying the tax treaty benefits,* ***if it is established, on facts, that the Mauritius company has been interposed as the owner of the shares in India, at the time of disposal of the shares to a third party, solely with a view to avoid tax without any commercial substance****."*

Judicial GAAR (JAAR) – Precursor to GAAR

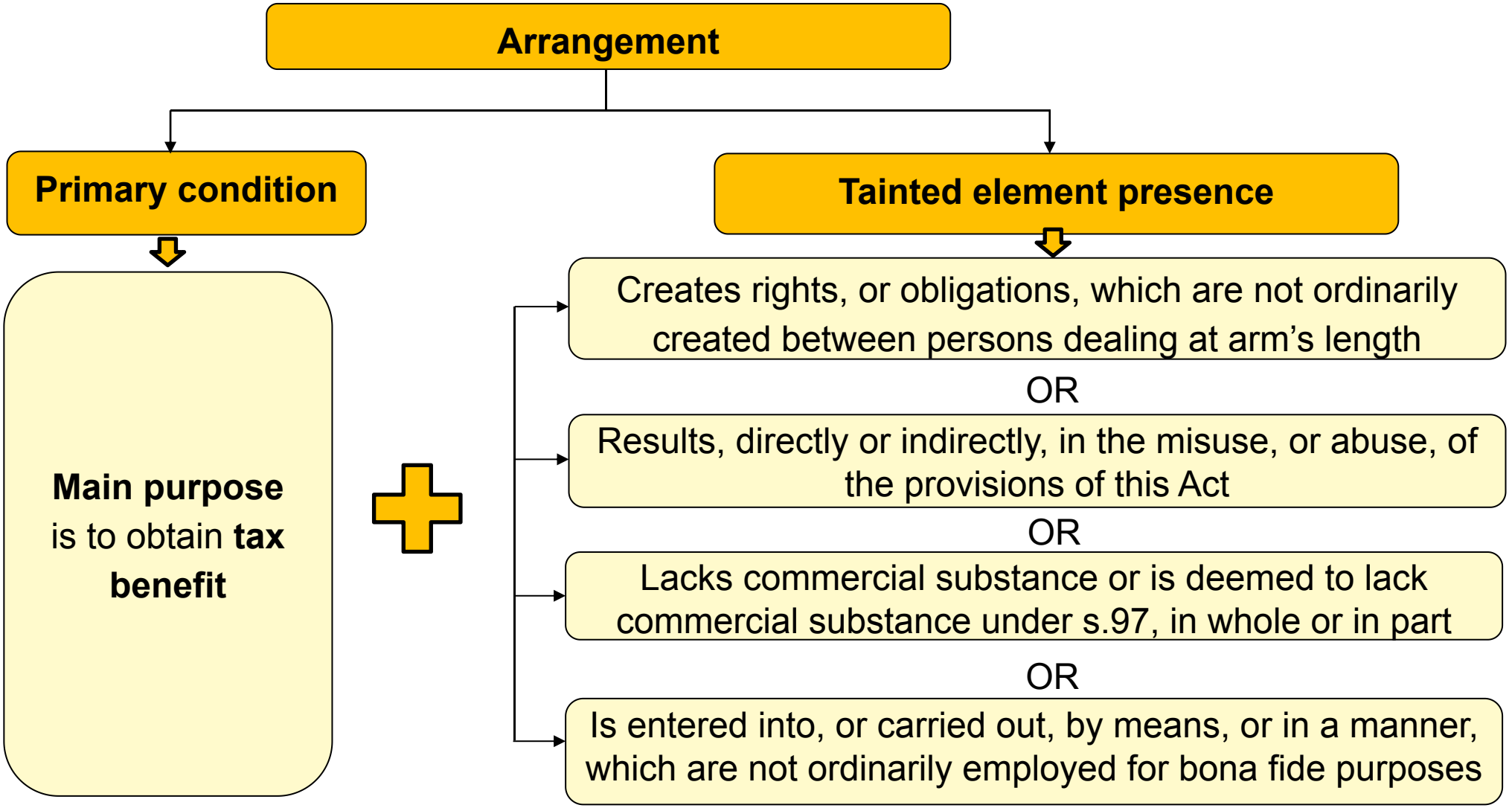
- **Azadi Bachao Andolan [2003] 132 Taxman 373 (SC):**

  "The situation in the United State is reflected in the following passage from American Jurisprudence:

  "…If a taxpayer at assessment time ***converts taxable property into non-taxable property for the purpose of avoiding taxation,*** *without intending a permanent change, and shortly after the time for assessment has passed, reconverts the property to its original form, it is a discreditable evasion of the taxing laws, a fraud, and will not be sustained…"*

Overview of GAAR

- An arrangement is an impermissible avoidance arrangement (IAA) if:



Shift from “look-at” approach

- “Look at” approach no longer survives
- Explain “why” have you done “what” you have done!
- Obtaining tax benefit cannot constitute legitimate reason
- “Purpose” lies in the mind of the progenitor
- Evaluate alternative counterfactuals in light of commercial objects
- Think from armchair of a businessman
- Purpose should be supported by adequate “substance”

Definition of “arrangement”

- S.102(1):

  “arrangement” means any step in, or a part or whole of,

  any transaction, operation, scheme, agreement or understanding,

  whether enforceable or not,

  and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding.”

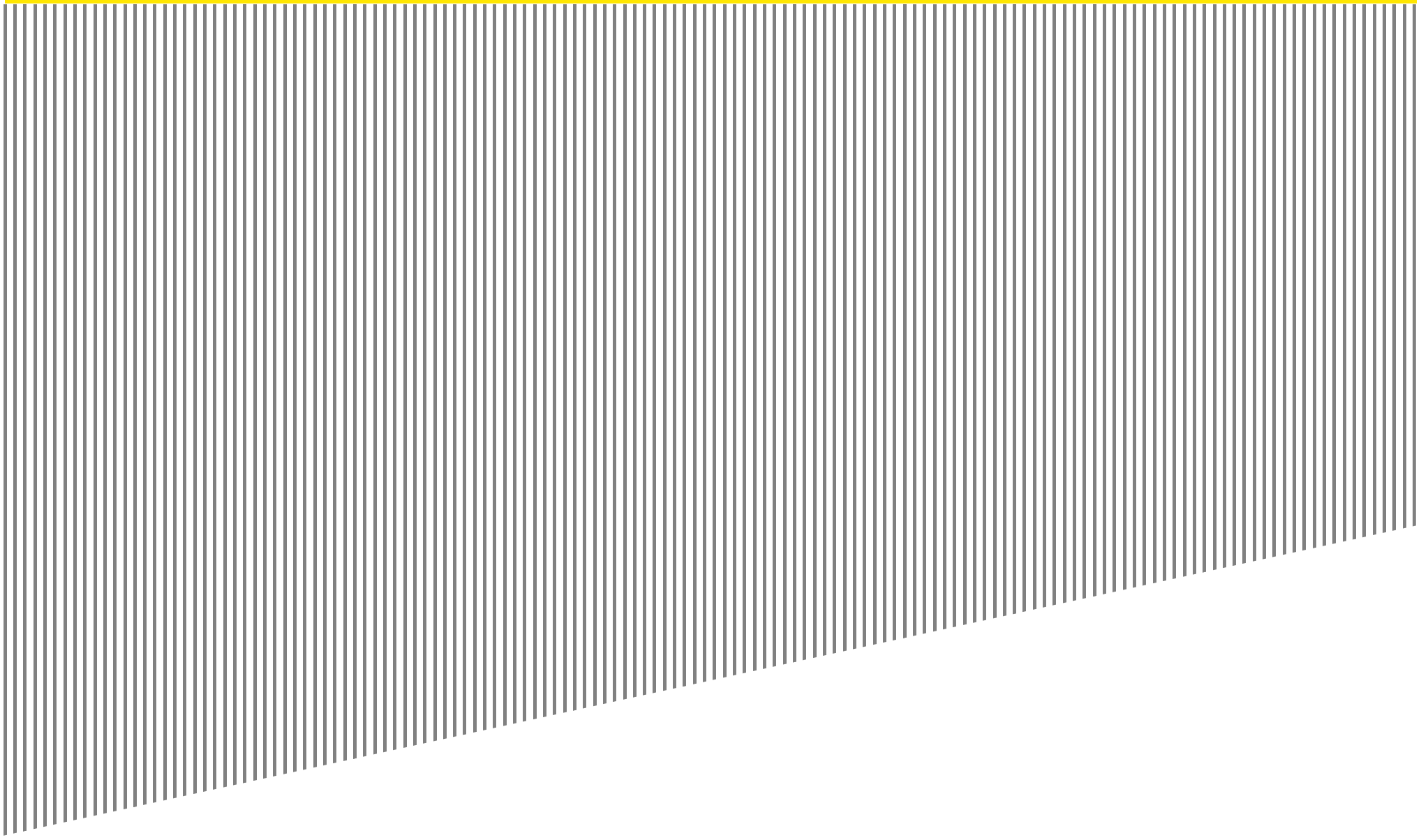
- Dictionary meanings of “operation” and “scheme”:

  Operation means *“an effect brought about in accordance with a definite plan; action”*

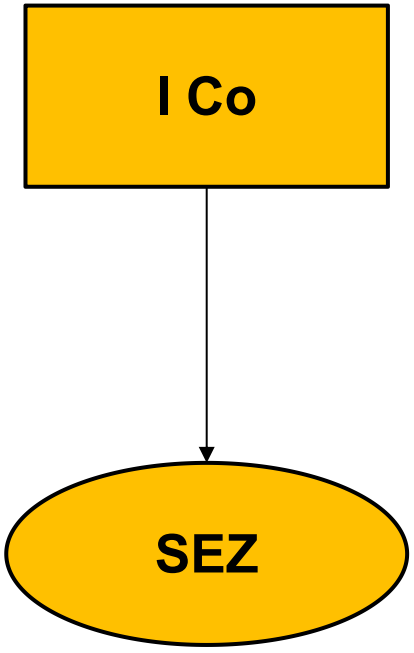
  Scheme means *“design or plan formed to accomplish some purpose; a plot”*

- Shifting residence to Dubai for rendering services
- Forming SPV in TFJ for routing investments into India
- Resignation by a director to avoid trigger of s.2(24)(iv)

Arrangement having commercial purpose

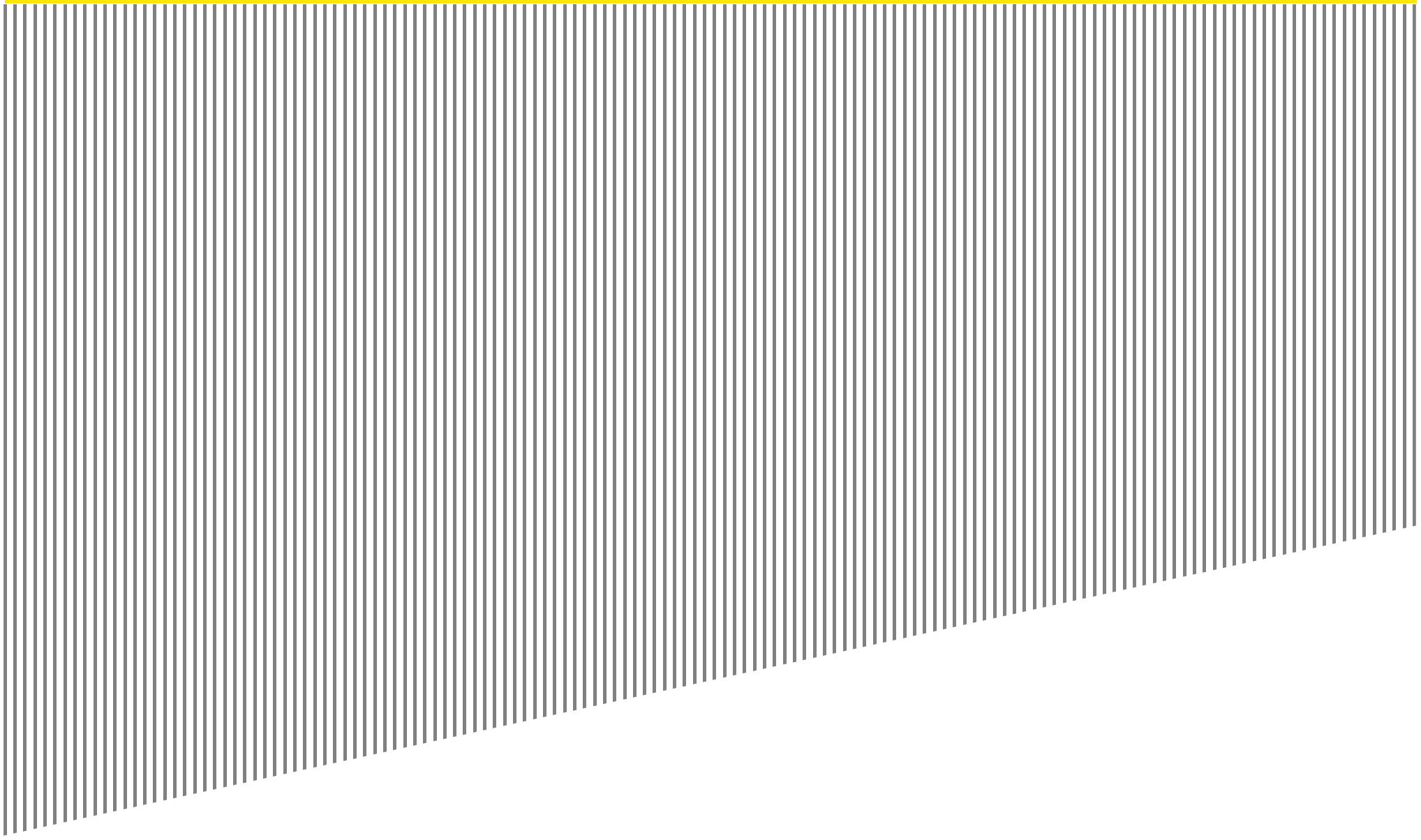


Setting up unit in SEZ notified area

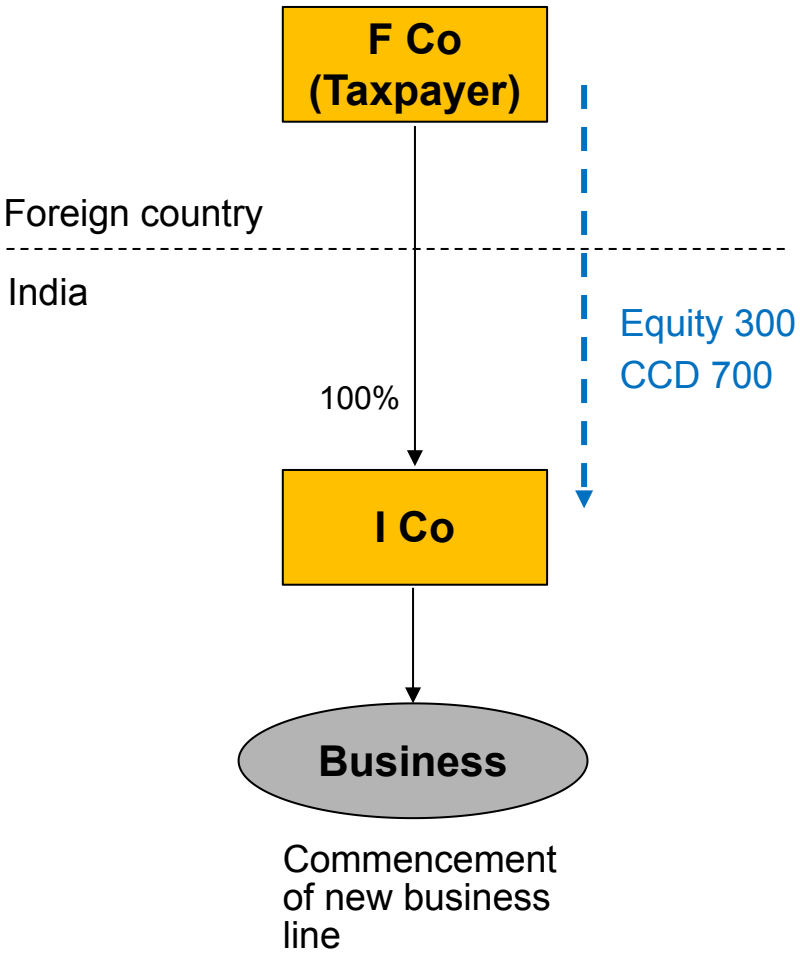


- I Co manufactures goods for ABC, being a major customer of I Co
- ABC has a condition that its supplier should be in the vicinity of 2 km radius from ABC's facility
- I Co already has a manufacturing facility at Location A, were one of ABC's facility is located
- ABC has set up additional unit in Location B and has offered that I Co can be a supplier provided that I Co also sets up an additional unit in Location B
- Location B is an industrially backward and SEZ notified area
- Primary driver to choose Location B was preventing loss of business from major customer; tax incentive is incidental
- **Issue:** Is choice of I Co to set up manufacturing facility in SEZ impacted by GAAR?

Choice principle

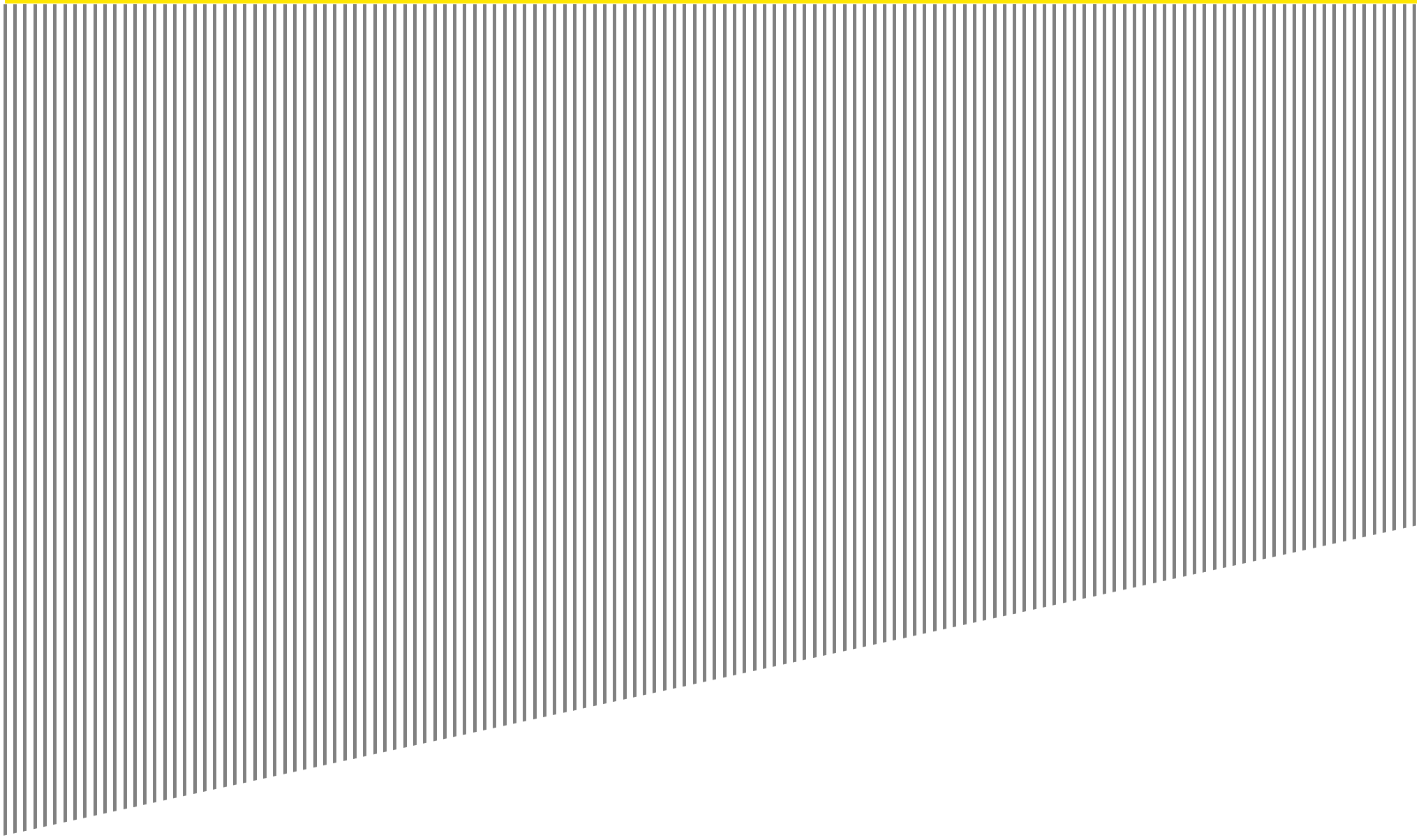


Re-characterization of CCD

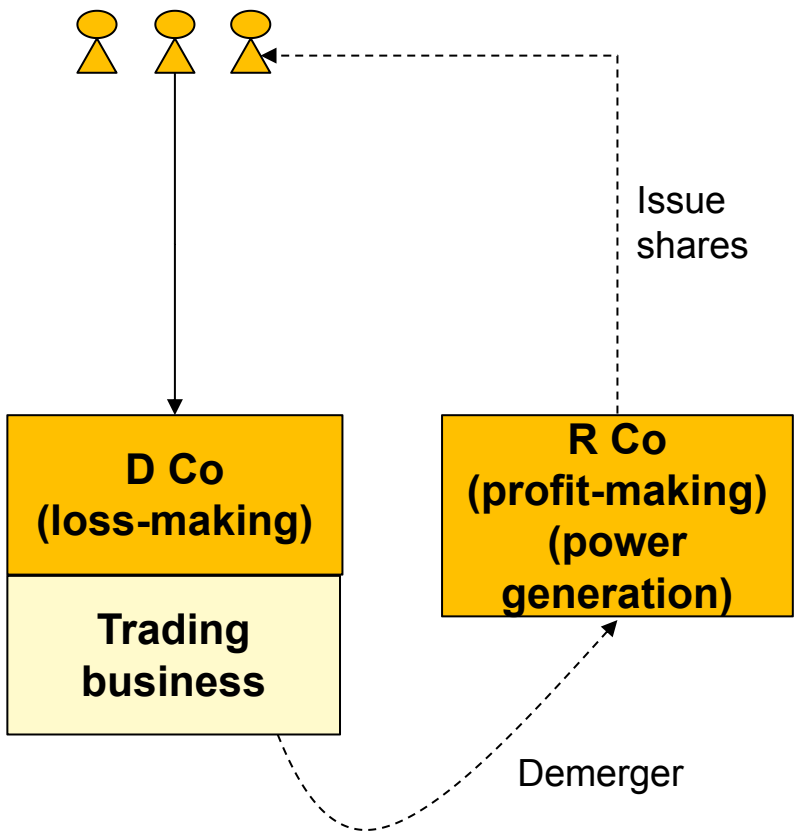


- I Co (owned 100% by F Co) requires funds in order to commence a new line of business
- F Co has internal accruals of 1,000
- In order to ensure a proper debt equity mix, F Co invested in I Co with equity capital of 300 and debt (CCD) of 700
- Terms of CCD:
  - Fixed coupon (at ALP); 10 years term; No voting rights
  - Unsecured; Conversion at FMV of equity shares on date of issue
  - Payable at par on liquidation, senior to all forms of capital
- CCD is split into Equity Component and Debt Component under Ind-AS
- **Issue:** Can CCD be re-characterized as equity under GAAR?

Artificial arrangement



Demerger instead of merger

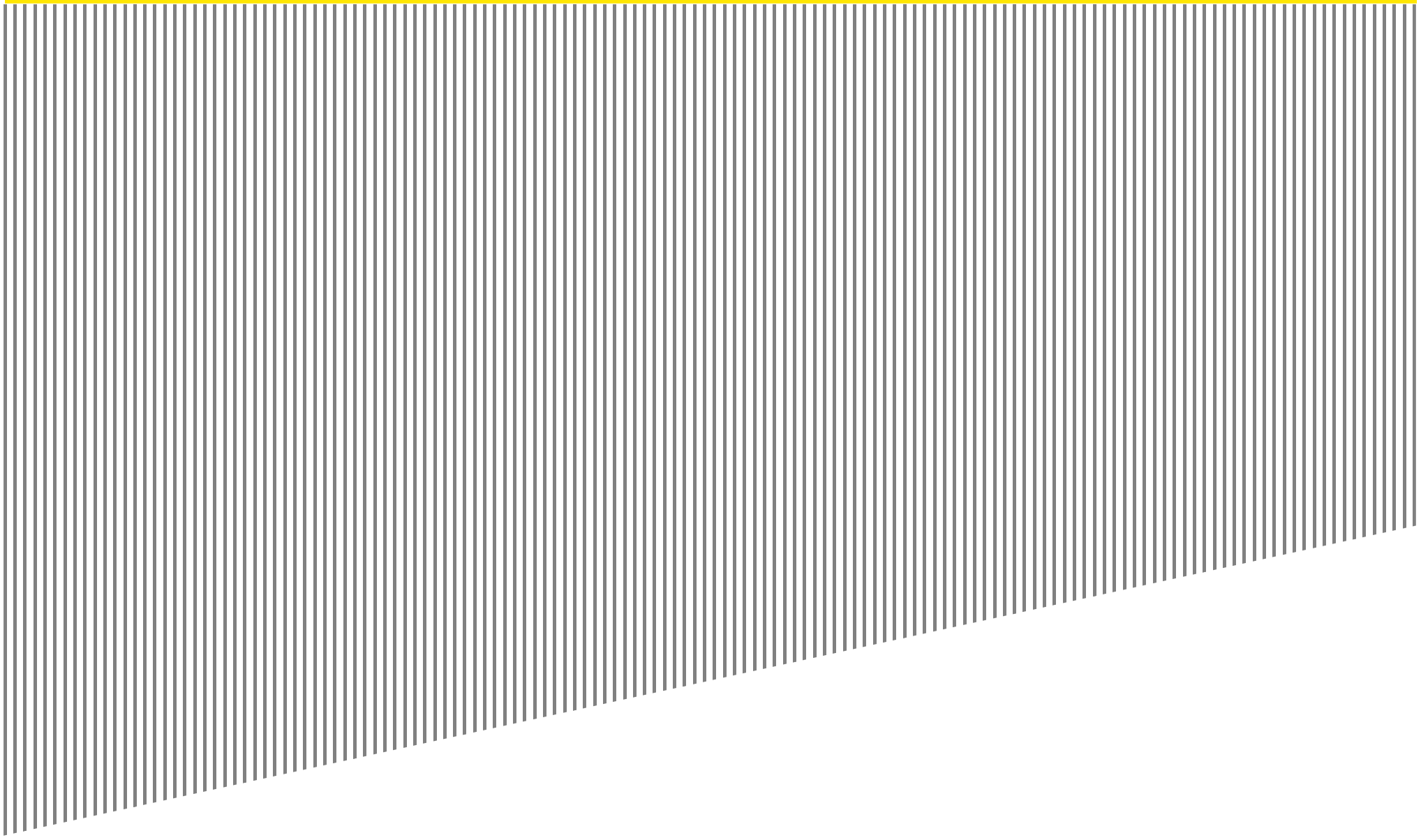


- D Co, a closely held company, is into trading business
- Over the years, D Co suffered substantial business losses
- R Co is into power generation business and making profits
- No business synergy between D Co and R Co
- R Co intends to acquire D Co's business
- S.72A conditions unlikely to be fulfilled if there is merger of D Co into R Co
- D Co's business is de-merged into R Co; and R Co issues shares to existing Promoters as consideration
  - Demerger is s.2(19AA) compliant
- Accumulated losses of D Co fully set off against profits of R Co in year of demerger
- R Co discontinues business of D Co after a year

Alternative fact pattern:

- D Co manufactures electricity charged batteries
- R Co is unsure of D Co's legacy and ongoing litigations
- Demerger ensures that ongoing litigation is not transitioned to R Co

Main purpose is tax benefit but no tainted element test is applicable



Investment in s.54EC bonds

- **Facts:**
  - Mr. A owns a certain parcel of land since 2000
  - Such land was sold in FY 2019-20; and Mr. A earned LTCG of INR 20 L
  - Mr. A invested entire LTCG in NHAI bonds notified u/s. 54EC and pays no tax
  - Considering that NHAI bonds have an interest rate of 5.75% against corporate fixed deposit rate of 7.55%, net-after tax yield calculation over 5 years may be as under:

    (Note: interest income on both instruments is taxable @ 30%)

	Calculation of interest	Interest income	Tax benefit of s.54EC	Total yield (undiscounted)
NHAI bonds	Interest = 20L*5.75% p. a. *5 years	5.75 L	4 L (20L*20%)	9.75 L
Corporate FD	Interest = 20L*7.55% p.a. *5 years	7.55 L	-	7.55 L

- **Issue:** Assuming threshold of Rs. 3 Cr. is absent, whether exemption u/s. 54EC can be denied under GAAR since main purpose of investing in such bonds is to avoid payment of capital gains tax?

PPT

OECD's concerns around treaty shopping

- Improper use of treaty, especially treaty shopping, was one of key concerns at OECD even prior to BEPS project. In 2003, OECD added following guiding principle to the commentary on Article 1:

> *"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*."

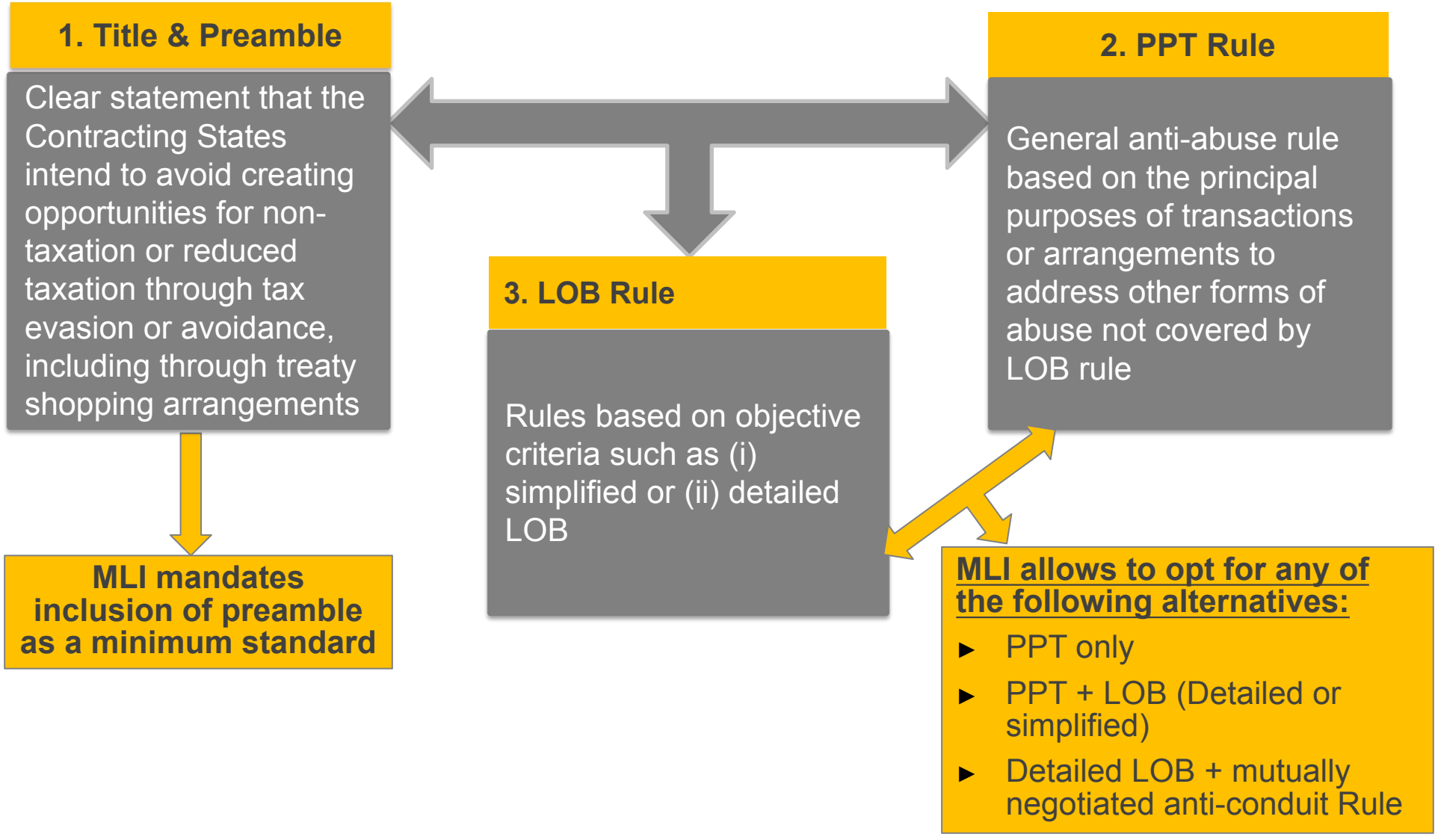
OECD's concerns around treaty shopping

- OECD measure under BEPS Action 6 - *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances deals with a variety of measures to control treaty abuse* (2015)

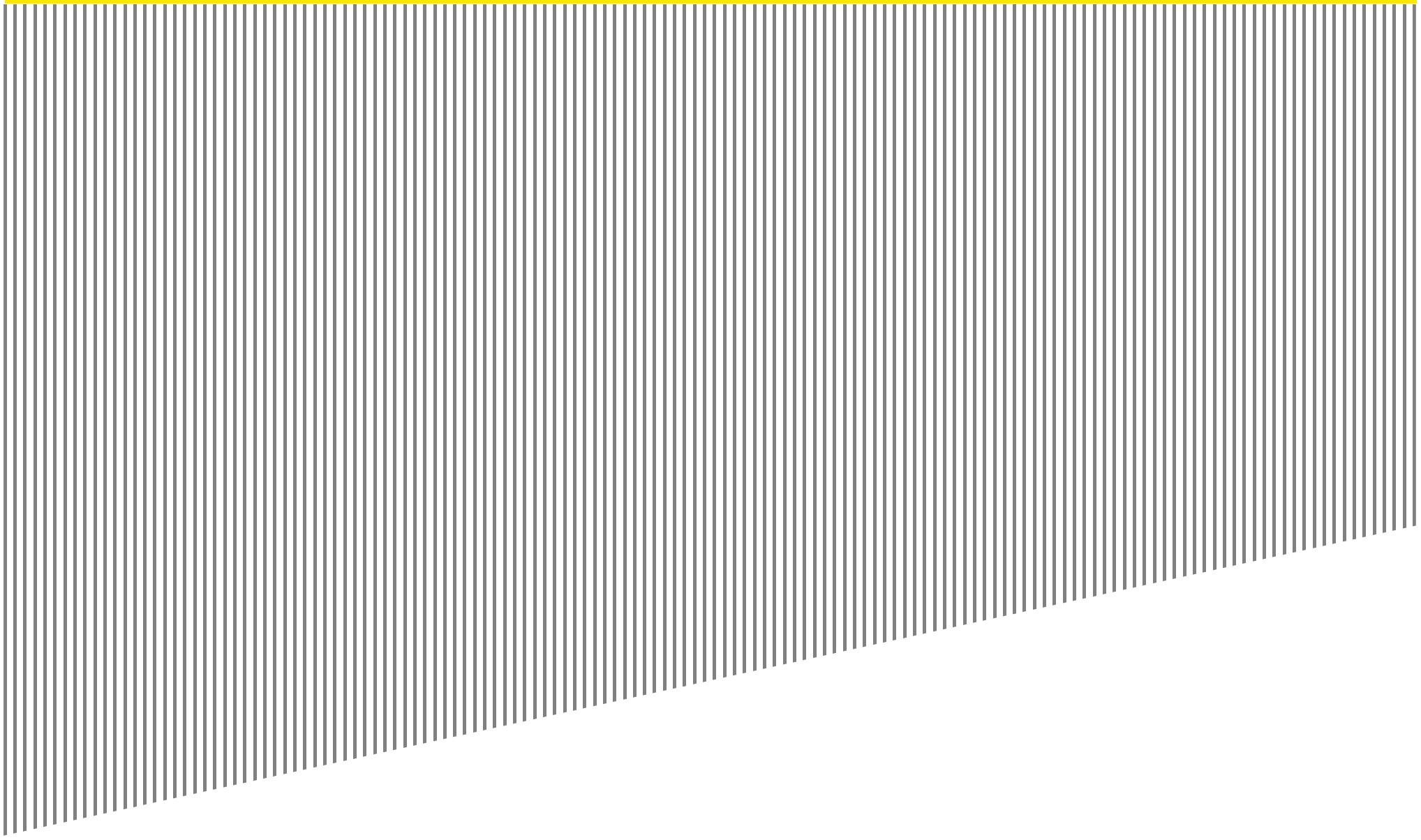
  "***Treaty abuse is one of the most important sources of BEPS concerns.*** *The Commentary on Article 1 of the OECD Model Tax Convention already includes a number of examples of provisions that could be used to address treaty-shopping situations as well as other cases of treaty abuse, which may give rise to double non-taxation.* ***Tight treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will contribute to restore source taxation in a number of cases."***

- Action Plan 6 is one of the minimum standards under OECD BEPS project

Three-pronged approach of BEPS Action 6 for prevention of treaty abuse



Article 6 of MLI – Purpose of CTA (Preamble)



Article 6 of MLI – Purpose of a CTA

- **Text of the Preamble:**

  "Intending to eliminate double taxation with respect to the taxes covered by this agreement ***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 agreement for the* ***indirect benefit of residents of third jurisdictions****)"*

- Being a minimum standard, requires insertion in CTA **in absence of** or **in place of** present text.

- **Optional additional text [not adopted by India]:**

  "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters"

Significance of *"Preamble"* in tax treaty interpretation

- **Article 31 of VCLT:**
  - *"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."*
  - *"The **context for the purpose of the interpretation of a treaty** shall comprise, in addition to the text, including its **preamble** and annexes:…"*
- **Guidance from BEPS Action 6:**

  *"73. The **clear statement of the intention of the signatories** to a tax treaty that appears in the above **preamble** will be relevant to the interpretation and application of the provisions of that treaty…"*

Significance of *"Preamble"* in tax treaty interpretation

- **Guidance from Explanatory Statement to MLI:**

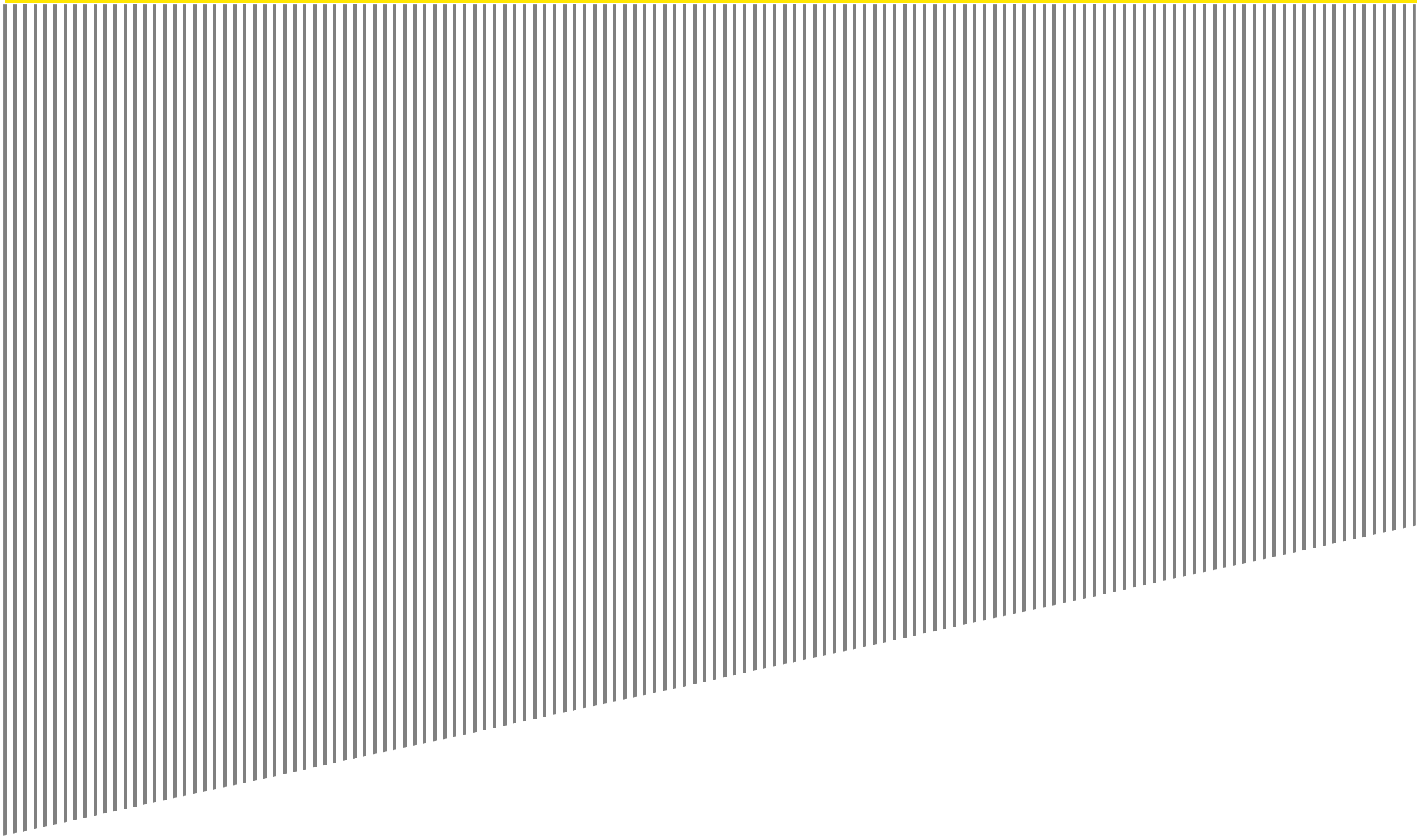
  *"23. The inclusion of this statement in the **preamble** to the Convention is intended to clarify the intent of the Parties to ensure that Covered Tax Agreements be interpreted in line with the **preamble** language foreseen in Article 6(1)."*

- **SC in Azadi Bachao Andolan (263 ITR 706)(SC)**

  *"…….that the **preamble** of the Indo-Mauritius DTAC recites that it is for the "encouragement of mutual trade and investment" and this aspect of the matter cannot be lost sight of while interpreting the treaty"*

- Whether SC conclusion would remain unchanged post MLI?
- Is preamble insertion sufficient to target abuse including of treaty shopping?

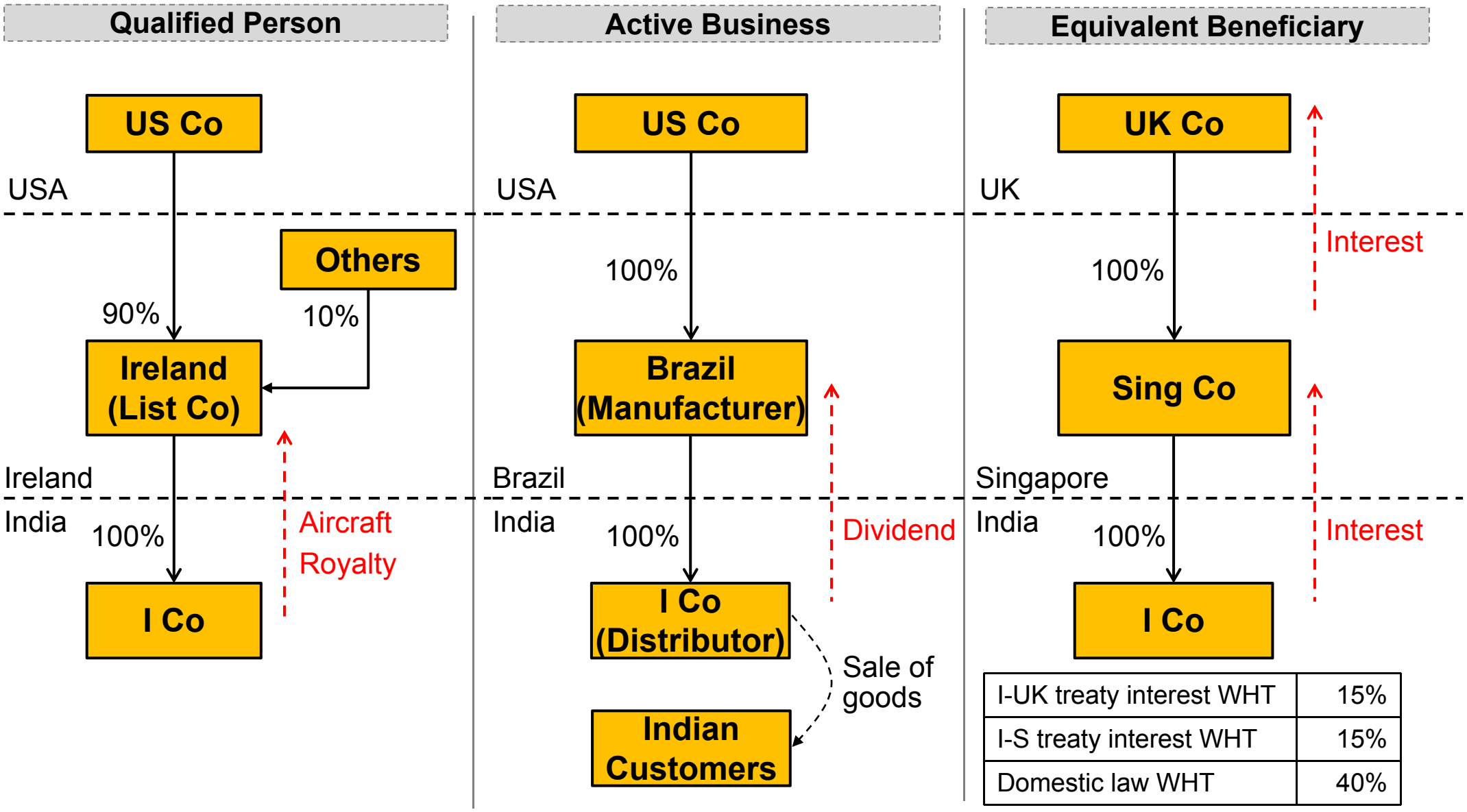
Article 7(8) to (13) – Simplified Limitation of Benefits (SLOB)



Article 7(8) to (13) – SLOB rule

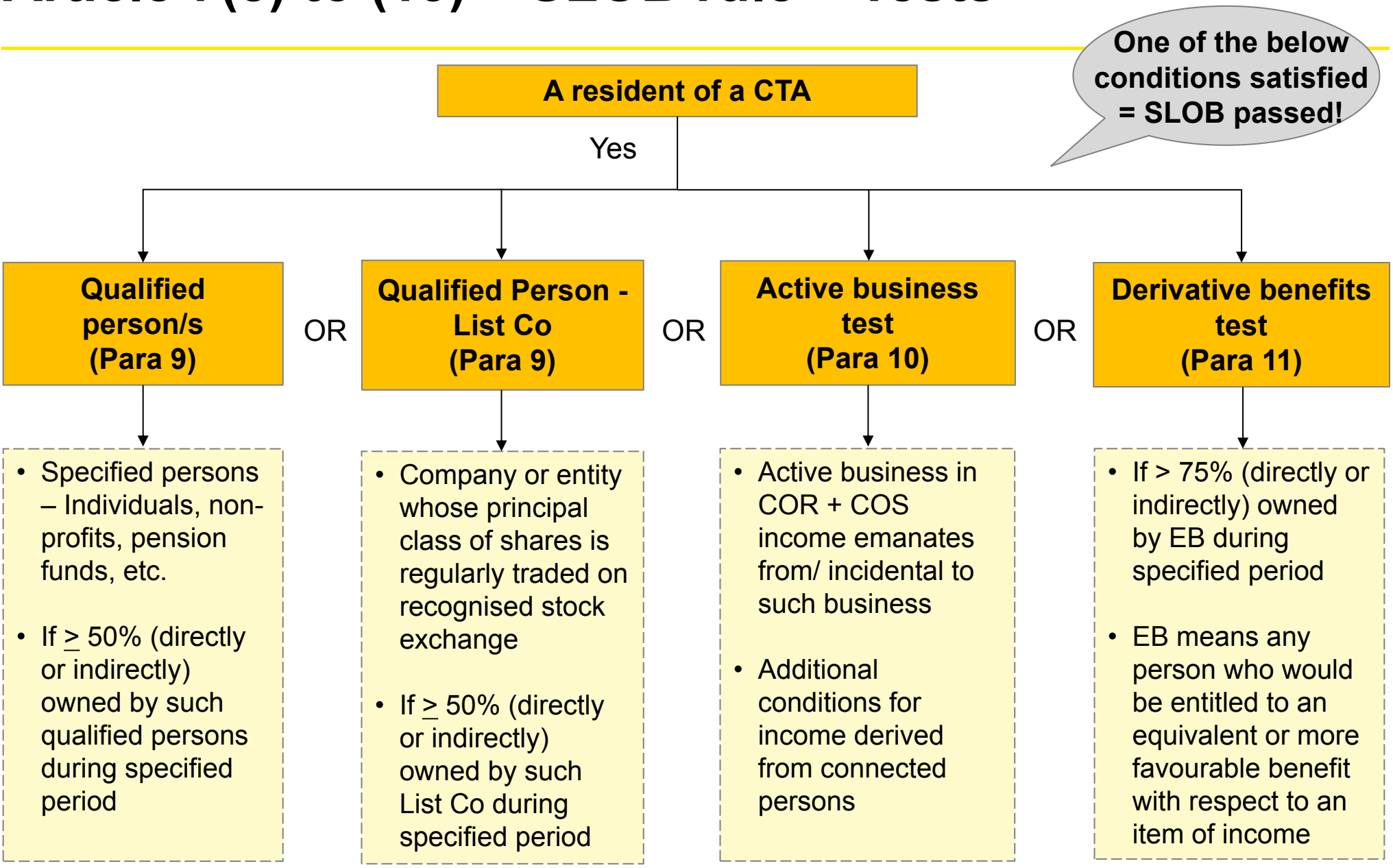
- SLOB is an **optional** clause, in addition to PPT
  - It is not a minimum standard
- SLOB is **applicable only when both the countries agree** for its application
- It is specific anti-abuse rule (SAAR) which **provides objective conditions** for determining entitlement to treaty benefits
- SLOB deals with **eligibility of the entity** and hence likely to be tested before PPT, BO, LOR or other limitations
- Even if test of SLOB is fulfilled, the treaty benefit may still be denied if it appears that in relation to a designated transaction or arrangement, PPT is not fulfilled
- SLOB criteria evaluated at the time of treaty benefit evaluation
  - Within the criteria, look back period envisaged for certain conditions

Article 7(8) to (13) – SLOB rule – Tests

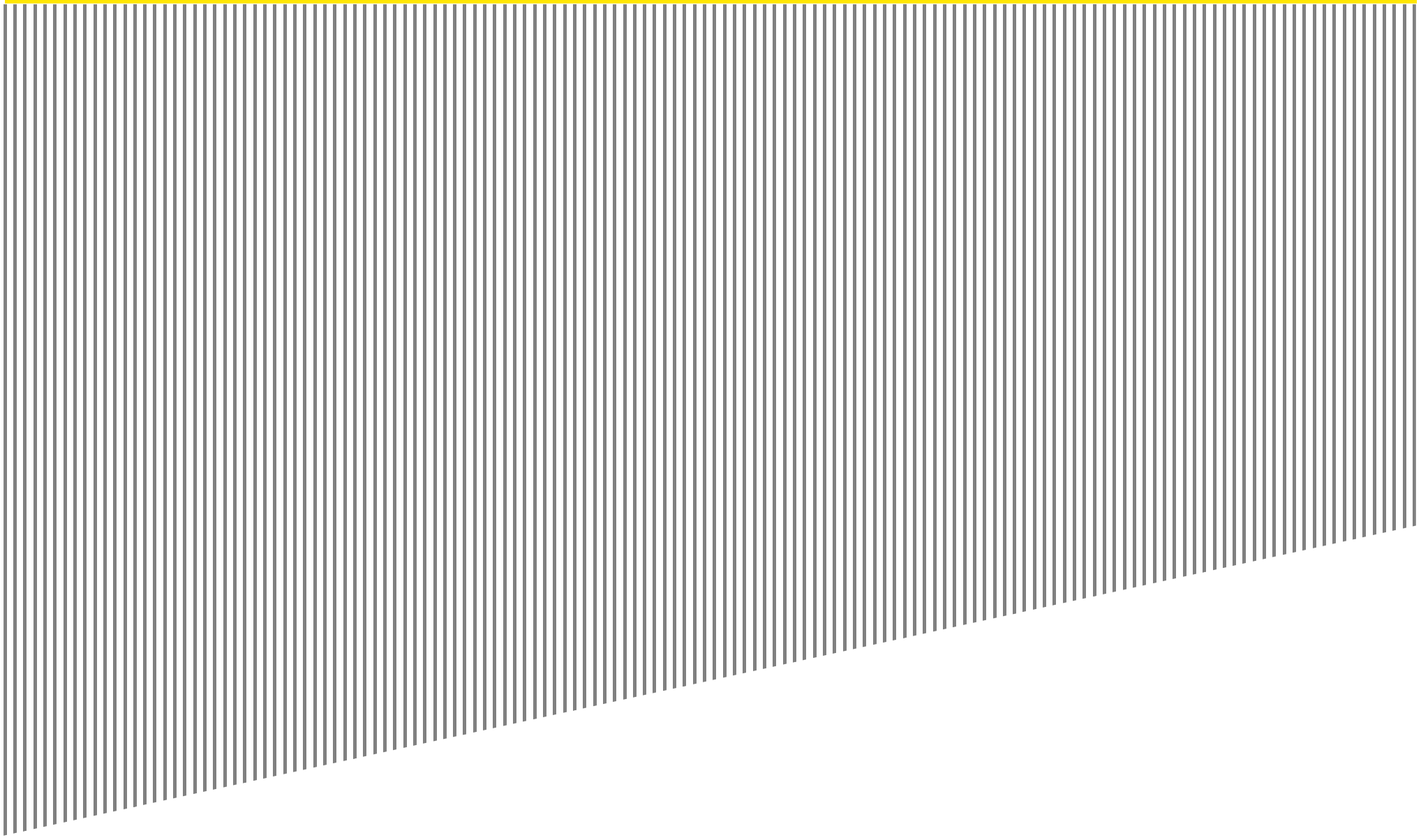


I-UK treaty interest WHT	15%
I-S treaty interest WHT	15%
Domestic law WHT	40%

Article 7(8) to (13) – SLOB rule – Tests



Article 7 of MLI - Principal purpose test (PPT)



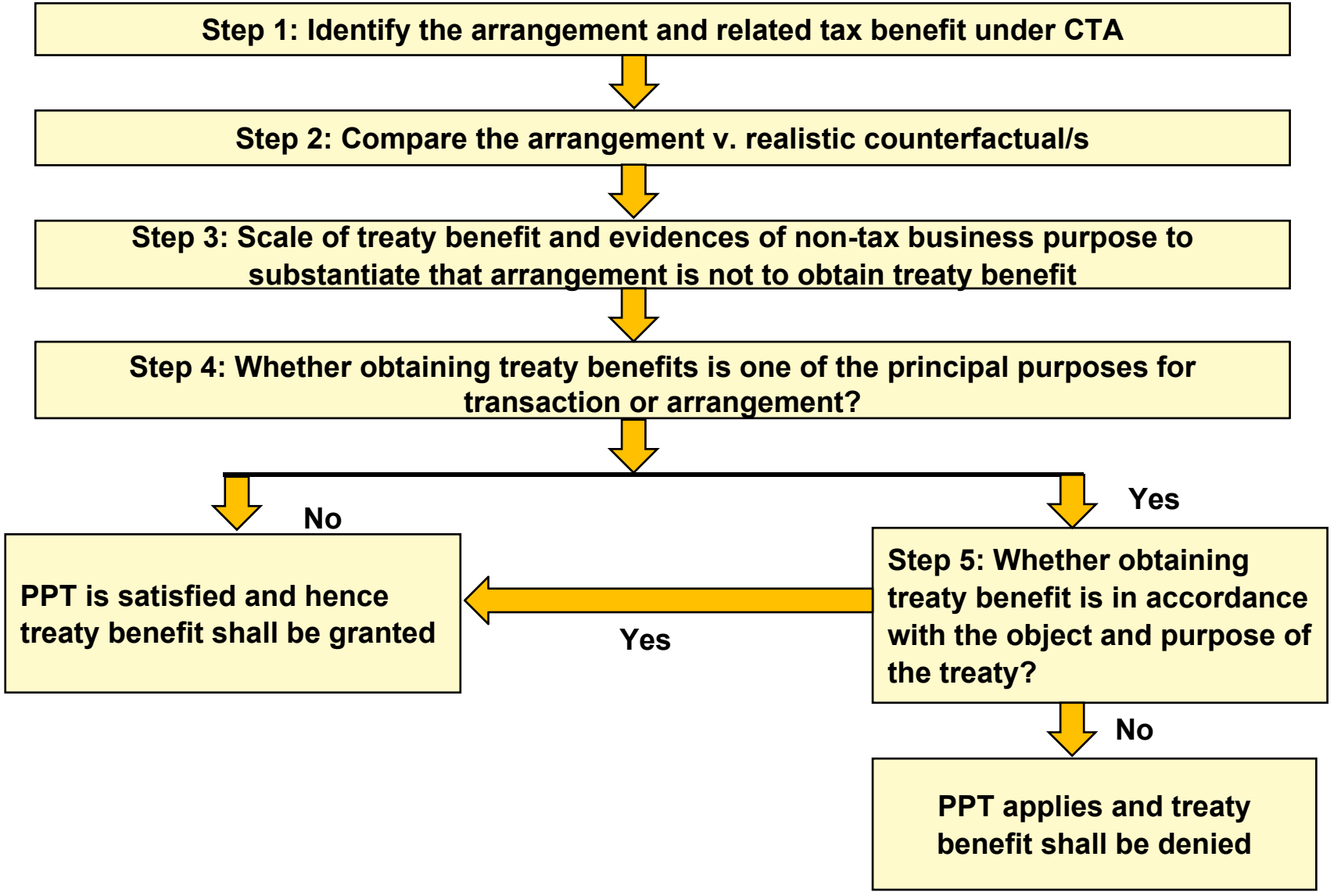
Article 7 of MLI – Prevention of Treaty Abuse

"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')

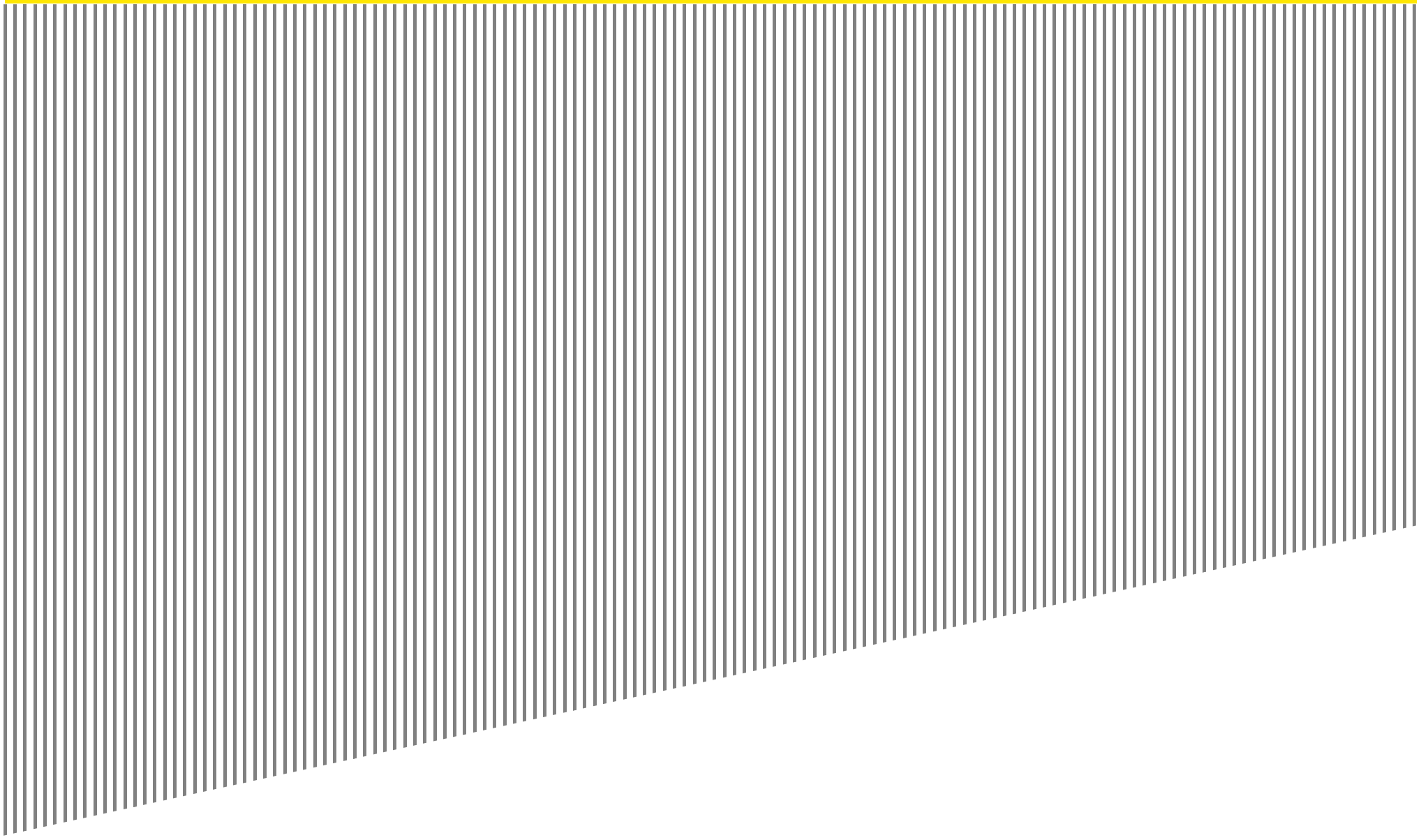
Unless

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')

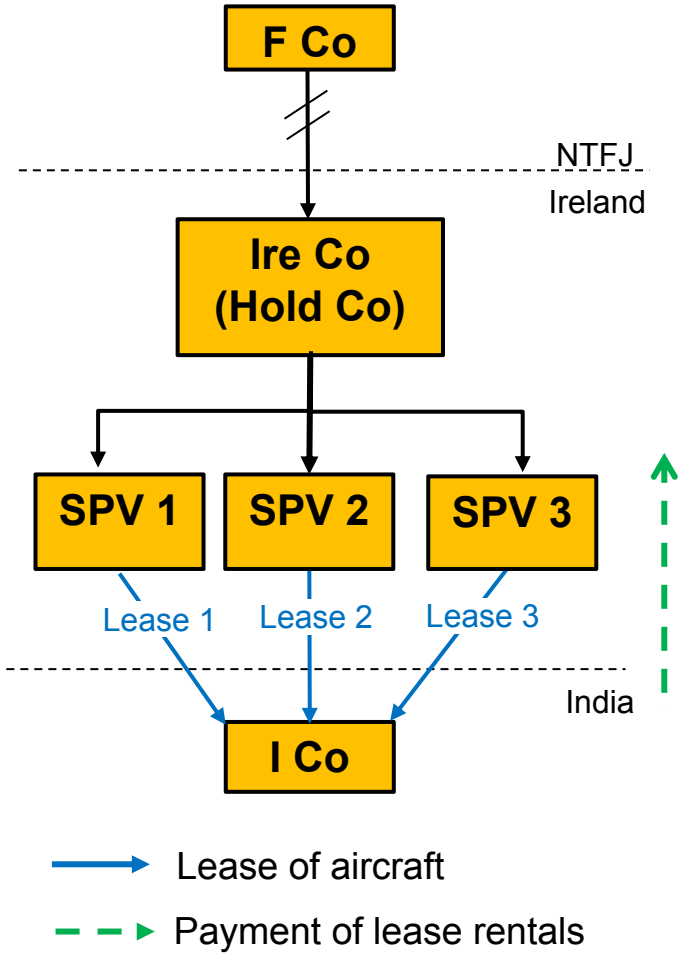
Step process for evaluation of PPT



Principal purpose is not to obtain treaty benefit



Leasing from Ireland



WHT under ITL	**@10% + SC**
WHT under India-Ireland treaty	**NIL**

- Ire Co is a well-established company in Ireland actively engaged in the business of aircraft leasing
- Most aircrafts are financed out of borrowings
- Ire Co prefers to have specific SPV per aircraft, inter alia to:
  - Facilitate borrowing, investor participation, ring fence liabilities, better protect commercials; etc.
- As financers' insist, aircrafts are acquired in separate SPVs
- I Co has entered into lease arrangements with 3 SPVs of Ire Co
- I Co makes lease payments to each SPV
- SPVs hold valid TRC and claim to be BO of rentals
- India-Ireland tax treaty stands modified by MLI with effect from 1 April 2020
  - PPT and Preamble gets inserted
- I Co remits rentals considering the treaty benefit

Meaning of arrangement

- OECD Commentary 2017 provides the interpretation of the term 'arrangement':

> *The terms "arrangement or transaction" should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. These terms also encompass arrangements concerning the* ***establishment, acquisition or maintenance of a person who derives the income,*** *including the qualification of that person as a resident of one of the Contracting States, ….*

- PPT is a non-obstante provision leading to denial of treaty benefit
  - "Benefit" covers all limitations on taxation imposed on the COS as also treaty benefit obtained in COR
- **For a typical holding structure, the taxpayer needs to explain reasons for having a separate entity and also non-tax reasons for establishing the entity in a given jurisdiction**

Commercial reasons why “Ireland” is a preferred destination

- A +40 year’s legacy in commercial aircraft leasing started back in 1975 with setting up of Guinness Peat Aviation (GPA), the then world’s largest commercial aircraft lessor
- With folding up of GPA, release of a cluster of companies in aviation leasing with a pool of expertise in lease law, sales, accounting and finance relating to aircraft leasing industry
- Vibrant Maintenance Repair and Overhaul sector to support technical maintenance of aircrafts
- 0% VAT on international aircraft leasing
- Stamp duty exemption on aircraft and certain aircraft related transactions
- Stable, transparent and efficient tax regime
- Member of EU, OECD and Cape Town Convention and Aviation Protocol – Providing various benefits to financers – speed, certainty and right to creditor to repossess aircraft asset
- Launch of a dedicated exchange by Ireland Stock Exchange for aviation related debt and other financial instruments
- University College, Dublin offers MSc in Aviation Finance course, set up in partnership with top aircraft leasing companies, to cater to industry needs of qualified professionals in aviation industry
- Host to two of the worlds’ biggest aviation conferences attended by approx. 4,500 delegatees

Commercial reasons for formation of Ire Co/ SPVs

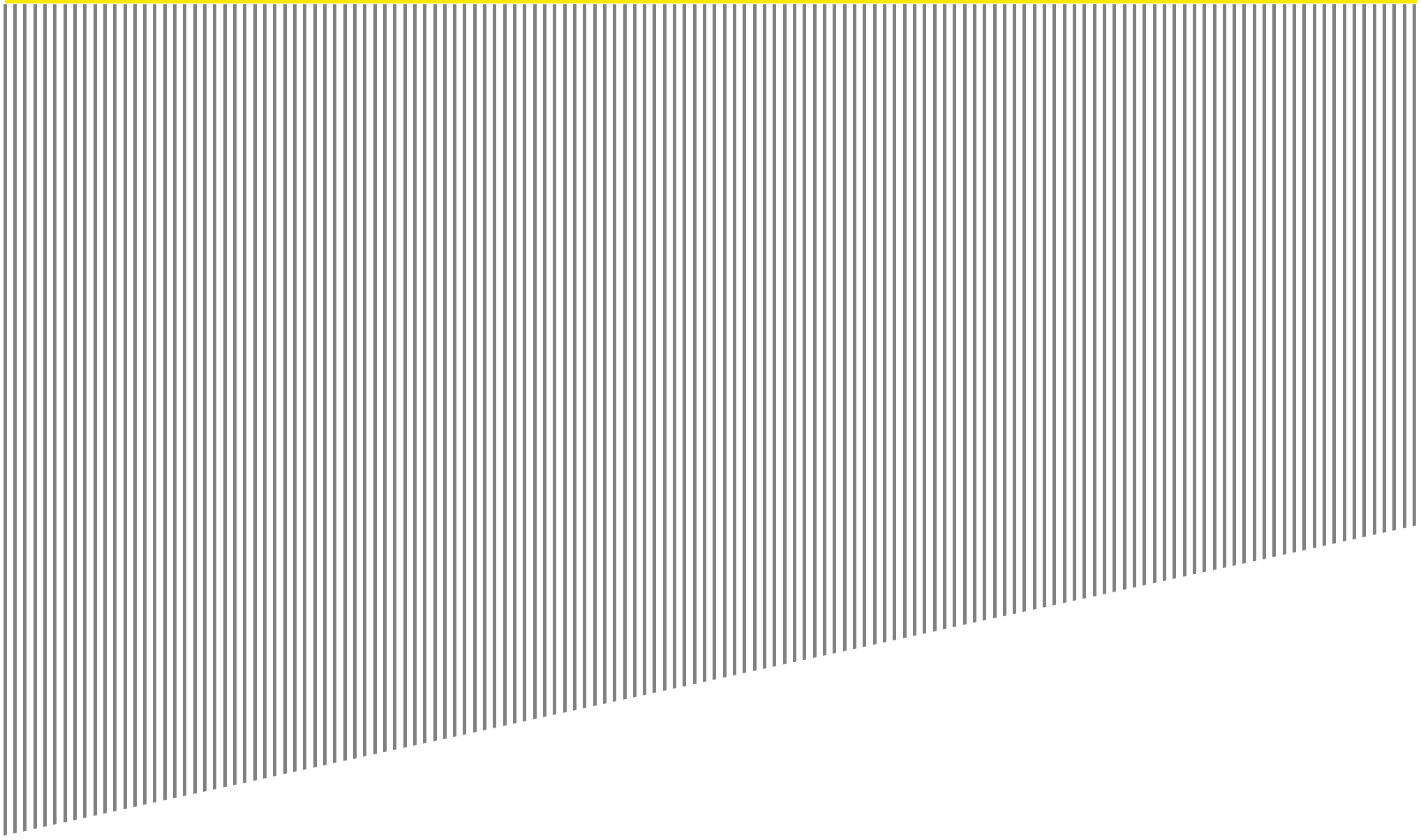
Illustrative Ireland specific commercials for setting up a separate SPV at Ireland

- In order to avail location specific benefits, companies are required to be resident of Ireland i.e. incorporated in Ireland
- Separate SPVs may be formed for housing each aircraft asset
  - Generally, third party debts are used to finance purchase of aircrafts
  - Third party lenders do not wish to co-mingle their aircraft assets with other assets for security in case of default
- Financers and airline lessees require financials of lessor entities – Easier to cater to requirement on individual SPV basis with limited disclosure of entire Irish Group

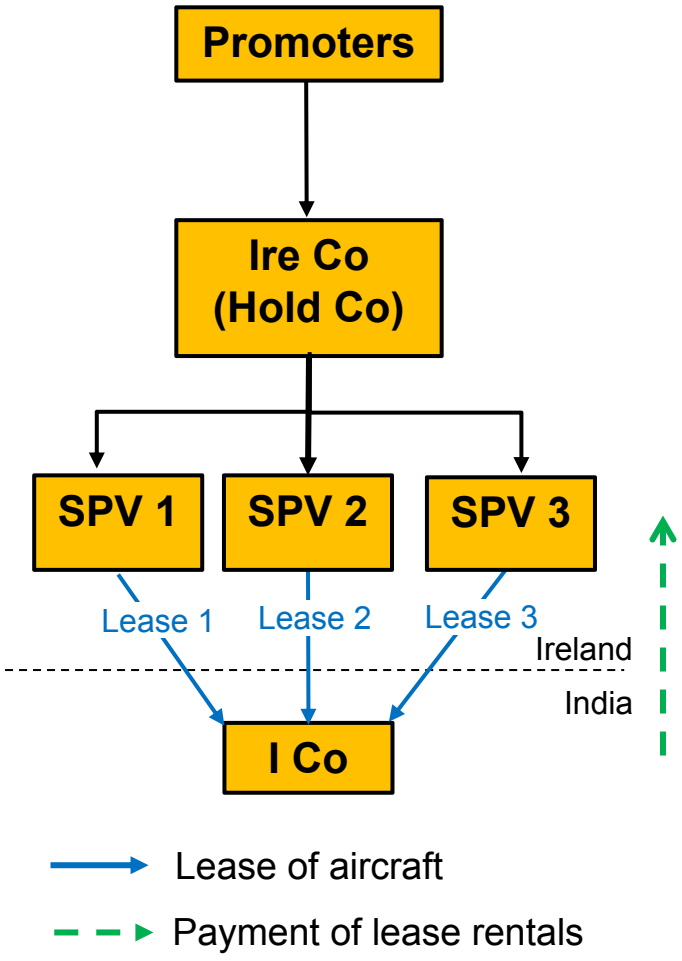
Illustrative commercial factors from Vodafone [2012] 341 ITR 1 (SC)

- Better corporate governance;
- Hedging business risk (for instance, high-risk assets may be parked in a separate company so as to avoid legal and technical risks to the MNE group) and political risk;
- Protection from legal liabilities; Mobility of investment;
- Enable creditors to lend against specified investment or division; creditors may not have to monitor the performance of the whole group; to limit the information which creditor should have;
- Promoting specialization; Facilitate an exit route;

Equivalent beneficiary

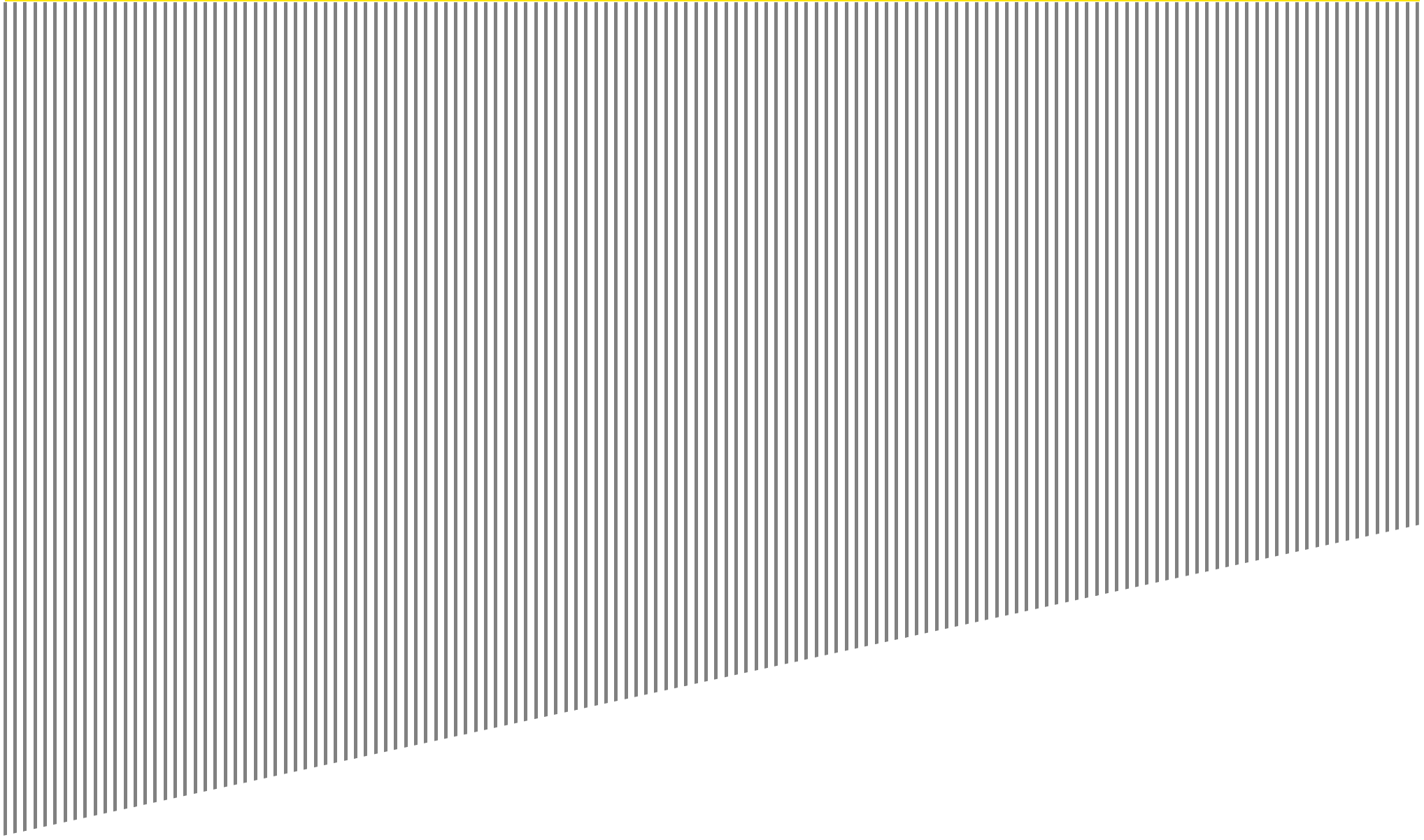


Ireland SPV held by Irish promoters

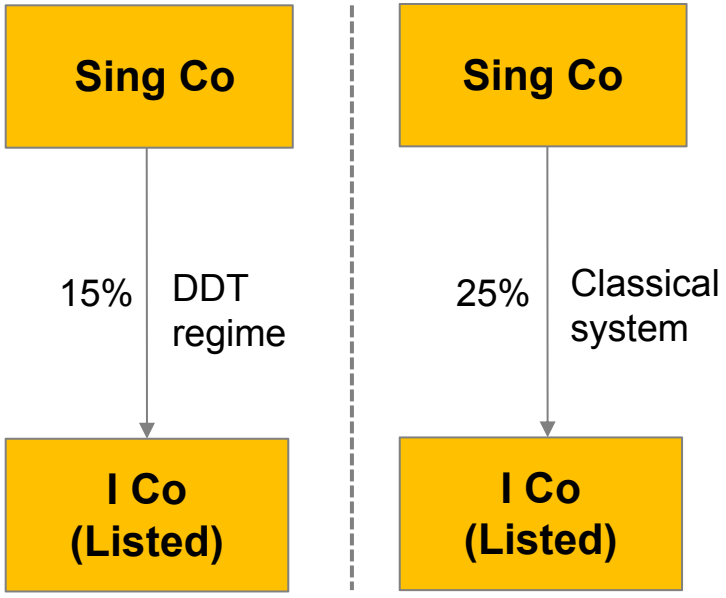


- SPV carries no activity other than owning aircraft simpliciter – separate SPV is created for each aircraft for commercial reasons
- Hold Co as also SPVs are treaty residents holding valid TRC/COR certificate
- As per taxpayer, main purpose of routing lease through SPVs cannot be tax benefit - as Ire Co is an “equivalent beneficiary”
  - “Equivalent beneficiary” means any person who would be entitled to an equivalent or more favourable benefit with respect to an item of income

Principal purpose is treaty benefit but saved by object and purpose carve-out



Increasing stake to obtain concessional treaty rate



- As on March 2020, Sing Co owns 15% shares in I Co
- DDT regime abolished from 1 April 2020
- Article 10 of I-S treaty provides that source taxation for dividend income is 10% if shareholder holds at least 25% of shares of I Co – otherwise, 15%
  - Article 8 of MLI (which provides for 365 days look back period) is not applicable to I-S treaty
- In April 2020, Sing Co increases stake to 25% by acquiring additional 10% stake from one of the other investors
  - Investor was persuaded to sell by offering slightly higher price
  - Principal purpose is to reduce source taxation for dividend income to 10% under I-S treaty
- Why granting treaty benefit is in accordance with object and purpose of relevant treaty provision? [Example E]

"That subparagraph uses an arbitrary threshold of 25% for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who ***genuinely increases its participation in a company in order to satisfy this requirement****."*

Object and purpose carve out

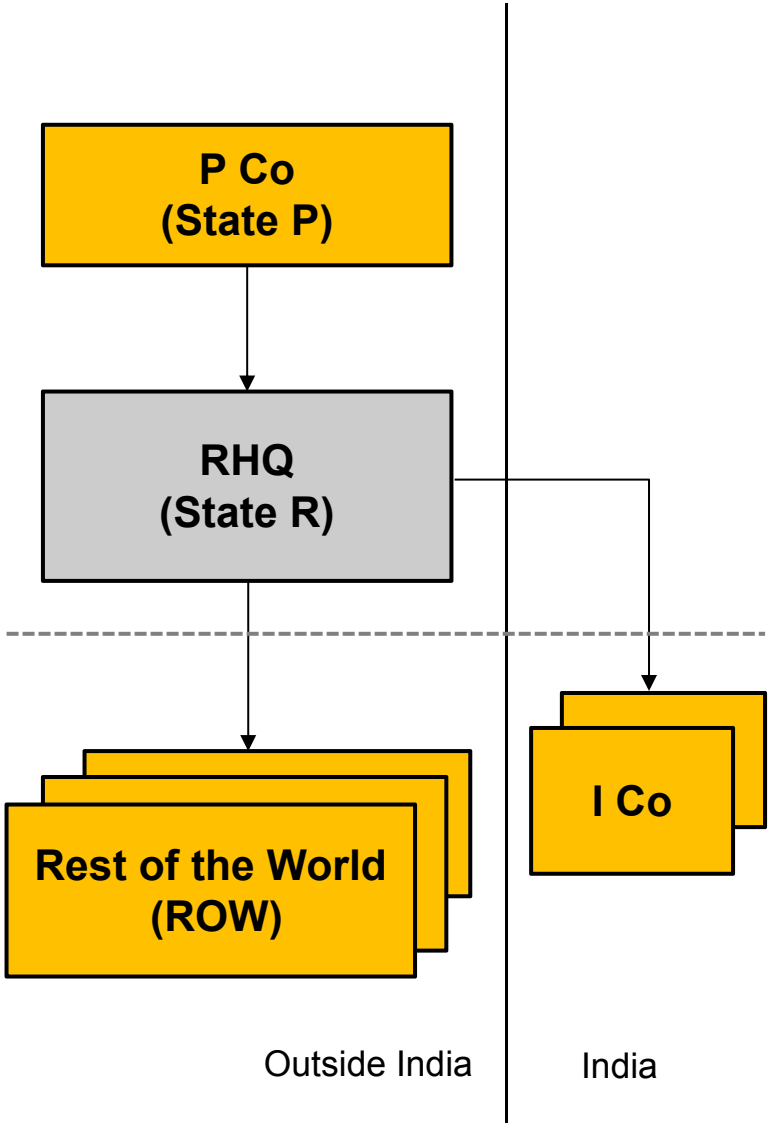
- **Treaty objects; object of a particular article[1]**
  - Eliminate double taxation: promote (bona fide) exchange of goods and services, and movements of capital and persons
  - Foster economic relations, trade and investment
  - Provide certainty to taxpayers
  - Prevent tax avoidance and evasion
  - Promote exchange of information
  - Strike a bargain between two treaty countries as to division of tax revenues
  - Eliminate certain forms of discrimination
  - Language of Preamble (as modified by MLI) to aid determination of object and purpose

[1] Commentary by Prof. Philip Baker titled "Double Taxation Conventions" at Para B.09 on Page B-7; OECD Commentary 2017 on Article 1; para 174 of OECD Commentary 2017 on Article 29(9); Linklaters LLP [2010] 40 SOT 51 (Mum.)

Other illustrative OECD examples on acceptance of treaty benefit

- Setting up manufacturing plant in low cost jurisdiction for expansion of business (Example C)
- Establishing intra-group service company in a jurisdiction with real business, real assets and real risks assumed (Example G)

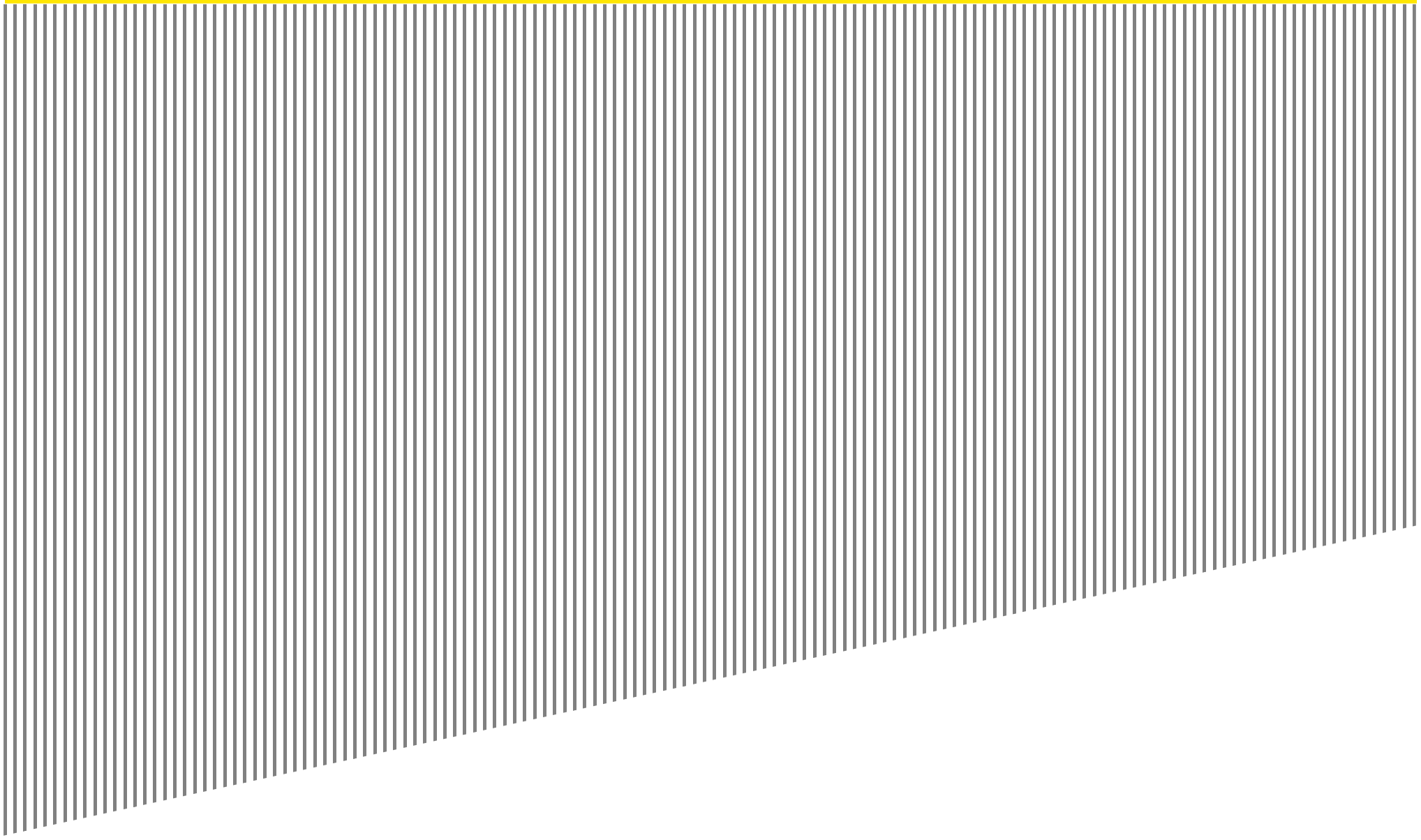
Effect of multiple treaties benefit



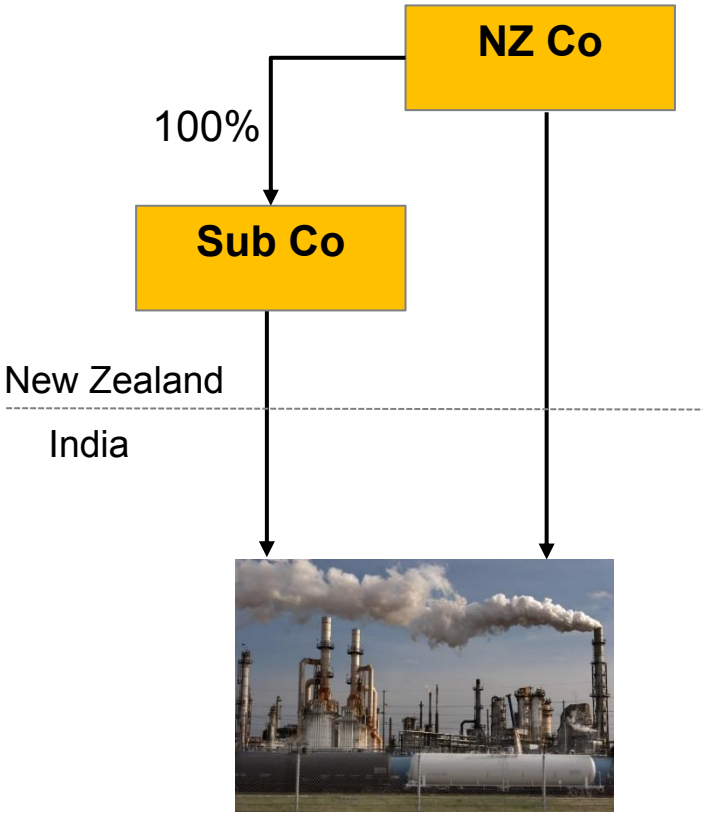
- RHQ holds multiple investment across globe/regions
- RHQ investment in Indian entities is miniscule compared to Rest of the World (ROW)
- RHQ is not able to explain commercial reasons for its presence in State R
- RHQ to take benefit of treaty network of country of its incorporation
- RHQ's claim: India cannot invoke PPT as tax benefit in India is not "one of the principal purposes" of its existence in State R
- OECD's take on impact of benefit arising from multiple treaties

  *"…..If the facts and circumstances reveal that the arrangement has been entered into for the principal purpose of obtaining the benefits of these (multiple) tax treaties, it should **not** be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement."*

Artificial arrangement



Facts



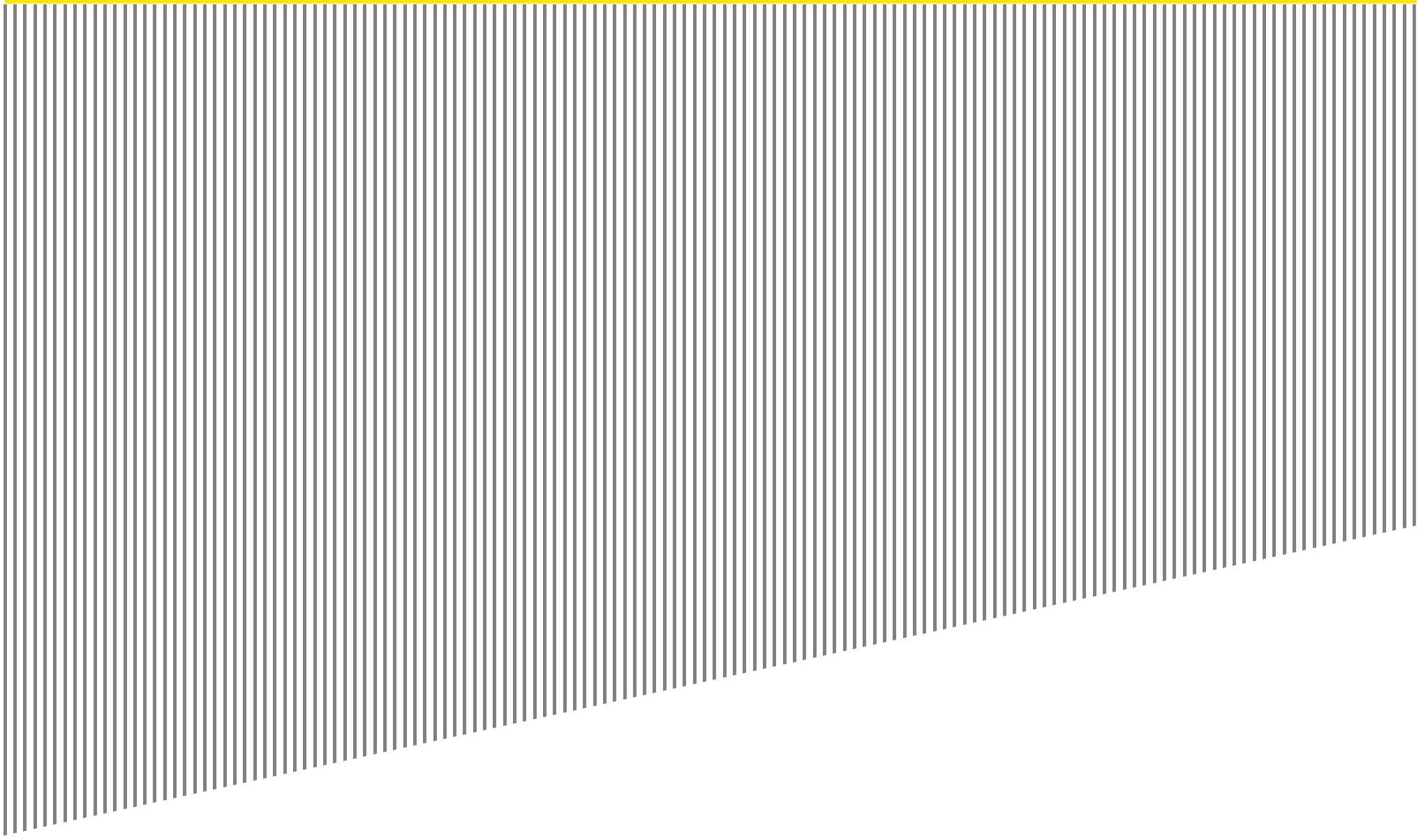
Power project in India of I Co

- NZ Co emerged as successful bidder for construction of power plant for I Co in India
- Construction is expected to last for 12 months
- Towards end of negotiations, separate contracts were entered into with NZ Co and its WOS (Sub Co) each for a 6 month duration
  - Sub Co newly formed specifically for the contract
- Sub Co to borrow infrastructure and employees of NZ Co for discharge of its obligation under contract
- NZ Co was jointly and severally responsible for performance of both contracts
- Under India-NZ treaty, construction PE threshold is triggered if the site continues for more than 6 months
- **Issue:** Whether PPT can capture such an arrangement?

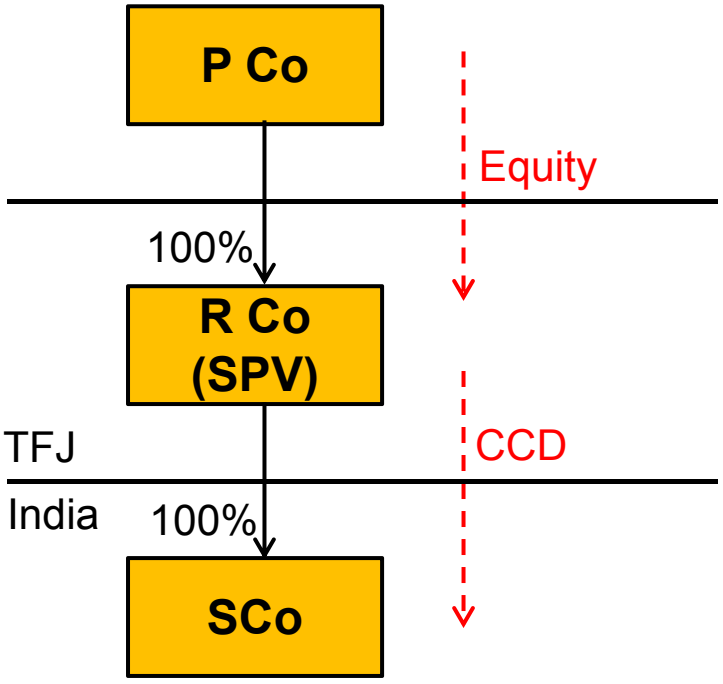
Alternative fact pattern:

- NZ Co itself executes the contract
- NZ Co deputes additional labour and infrastructure to complete 12 month contract in 6 months

Consequences of PPT



Facts



R-S Treaty Interest WHT	7.5%
P-S Treaty Interest WHT	15%
Domestic law WHT	40% + SC

- P Co has 100% subsidiary R Co; that has 100% subsidiary S Co
- R Co issues equity to P Co; S Co issues CCDs to R Co
- P Co and R Co hold valid TRC and are entitled to treaty benefit
- S Co pays interest on CCDs to R Co at ALP
- CCD is a valid debt instrument; CCD is not re-characterized as equity
- Interest is deductible in hands of S Co and is subject to WHT @ 7.5%

Tax Authority contentions for applicability of domestic rate on PPT trigger

- PPT applicable as R Co has been established and maintained for one of the principal purpose to obtain lower WHT rate
- PPT has absolute effect of denial of treaty benefit on abusive transactions
- PPT works on 'all or none' approach; it does not look beyond R-S Treaty except under discretionary relief mechanism
  - India (as source state) has not opted for discretionary relief provision
- Deterrent effect of PPT will be diluted if taxpayer (R Co) is permitted to have consequential relief which he would have obtained but for such tainted arrangement
- As per OECD, this is called 'cliff effect' – hence, specific discretionary relief provision is recommended

Taxpayer's contentions on applicability of concessional rate of P-S treaty

- PPT leads to denial of 'benefit' from tainted arrangement
  - PPT trigger happens only post identification of tax benefit
  - Dictionary meaning of 'benefit' suggests some improvement in condition
    - By implication suggests denial of "incremental favourable position" obtained due to tainted arrangement
- PPT consequences cannot be harsher than domestic GAAR
  - Identification of tax benefit happens by comparison with 'counterfactual'
  - Consequences should also be based on realistic counterfactual
  - A fair "counterfactual" in the case is to relate funding in S Co directly by P Co
  - If treaty consequence for domestic GAAR invocation is based on reattributed/ re-characterised arrangement, PPT as a treaty GAAR, no different
- Discretionary relief (which can grant same or different benefit) is an inbuilt good practice and indicator of fair play
  - Indicative of righteous and reasonable course of action that should be followed

PPT and GAAR interplay

PPT and GAAR interplay

Particulars	Domestic GAAR	Article 7 of MLI (PPT)
Applicability	It is a provision of domestic ITA	It is provision found in CTA pursuant to BEPS Action
What it seeks to control?	Tax benefit under domestic law as also treaty	Tax benefit under treaty
Conditions which attract the provision.	• Main purpose of arrangement is to obtain tax benefit; and • One of the tainted element tests is present	• One of the principal purposes of the arrangement is treaty benefit; and • Such treaty benefit is not in accordance with object and purpose of treaty
Methodology of finding purpose	Analysis of commercial and non-commercial purposes – usually by reference to counter-factual	Analysis of commercial and non-commercial purposes – usually by reference to counter-factual
Which tax benefits are denied?	All tax benefits flowing from tainted arrangement are denied	Deny only treaty benefit that constituted one of the principal purposes
Consequences	Re-characterization of transaction, re-allocation of income (includes denial of treaty benefit)	Denial of treaty benefit

Para 79 of 2017 OECD Commentary:

"To the extent that the application of the (domestic) rules results in a re-characterization 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……."

PPT and GAAR interplay

Particulars	Domestic GAAR	Article 7 of MLI (PPT)
Onus	Primary onus on tax authority, but facts to be supplied for taxpayer	Primary onus on tax authority, but to the extent it is reasonable to conclude
Administrative safeguards	Approving Panel	• To be determined by respective states • OECD and UN Model Commentaries suggest this (but, none so far for India)
Withholding agent	Is PPT, like GAAR, a measure to be invoked by tax authority against primary taxpayer alone and hence no cognizance to be taken/ possible at the stage of credit/ payment? • S.163 obligation onerous and ring fenced only with the help of order obtained u/s. 162(2)	
Can it apply to past arrangement	Yes, to the extent of benefit which accrues in AY 2018-19 and onwards.	Yes, to the extent, benefit is accruing after CTA is in force
Any Grandfathering?	Yes, only for income arising from transfer of past investment (prior to 1 April 2017)	No
De-minimis threshold	Yes – INR 3 Cr. in the aggregate for arrangement per year	No

Whether taxpayer can contend non-applicability of PPT by virtue of s.90(2A) of ITA?

S. 90(2A) - *"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."*

Preferred View: GAAR and PPT both are applicable

- Treaty is a self contained code
- Treaty benefits are subject to satisfaction of all the conditions provided in treaty, including SAARs and PPT
- An agreement granting relief has ability to put conditions subject to grant of relief
- If PPT triggers, there is no treaty benefit available for comparing with domestic law under s. 90(2)
- S. 90(2A) mandates domestic GAAR but does not negate treaty SAAR/ PPT operation

Concluding thoughts

- As security between borders tightens, benefits one claims under treaty will also be available under strict vigilance
- **Błażej Kuźniacki -** World Tax Journal, 2018 (Volume 10), No. 2

  "One of the basic functions of tax treaties seen in light of the rule of law is to guarantee certainty for taxpayers engaged in international commerce enabling them to predict the tax-related implications of their cross-border activities. The vagueness of the PPT and the wide discretion it hands to tax authorities endanger this function of tax treaties. In an extreme scenario, it may undermine the very rationale for entering into tax treaties, that being to enhance international commerce. ***One might say that the introduction of the PPT has the potential to mirror the treaty abusive practices of taxpayers. Just as taxpayers abuse tax treaties through their treaty shopping practices, so too may tax authorities by applying the PPT.****"*
- **S. E. Dastur**

  "GAAR will lead to prolific litigation - I daresay in the future, a substantial part of the litigation will centre around Chapter X-A of the Income-tax Act bearing in mind the very wide, if not wild, provisions which have been enacted."

Thank You