

# Understanding General Anti-Avoidance Rules ('GAAR'): Part 1



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**The provisions of Chapter X-A of the Income-tax Act, 1961, which prescribe General Anti-Avoidance Rules ('GAAR'), have been made applicable to all transactions entered into on and from 1st April 2017. The provisions are complicated and are likely to lead to numerous controversies and litigation between the taxpayer and the income-tax department. CA Paras Dawar has explained the salient aspects of the legal provisions in a simple and easy-to-understand format**

## **1. Introduction**

Parliament by Finance Act, 2012 inserted Chapter X-A under Income Tax Act, 1961 ('Act') which provided General Anti-Avoidance Rules ('GAAR') to be applicable from April 1, 2012. However, the protest from industry which feared arbitrary usage of power by tax officers forced the government to defer its implementation and to constitute an Expert Committee under the chairmanship of Dr.Parthasarathi Shome to frame guidelines for GAAR after consultations with all the stakeholders. Following the report of Dr.Shome Committee, various amendments were carried out under the tax law and clarifications were provided by CBDT through issue of Circular. With effect from April 1, 2017, GAAR have finally become effective.

In this article, an attempt has been made to decipher the complicated provisions of the Act dealing with GAAR.

## **2. Tax Avoidance**

Tax planning and tax avoidance, although legal ways to reduce taxes, are separated by a very thin line which at times is indistinguishable. While tax planning involves minimizing tax outgo by use of fiscal incentives available under tax legislation. Tax Avoidance on the other hand involves arranging affairs predominantly / mainly to obtain tax advantages without breaching the law. It involves the legal exploitation of tax laws to one's own advantage. Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers as colourable device to evade taxes.

## **3. GAAR Applicability**

Section 95 of the Act is the basic section that provides for declaring an arrangement entered into by a tax payer as an impermissible avoidance arrangement. It may be noted that section 95 of the Act overrules the entire Act and shall have operation notwithstanding anything contained in the Act.

Even in cases where relief is available under Double Taxation Avoidance agreement ('DTAA'), the tax payer will still be continued by the provisions of GAAR by virtue of section 90(2A) of the Act. CBDT vide Circular No. 7 of 2017, dated 27-1-2017 further clarified that 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 sufficiently addressed by Limitation of Business ('LOB') in the treaty, there shall not be an occasion to invoke GAAR.

Rule 10U of the Income Tax Rules, 1962 ('Rules') restrict applicability of GAAR only in cases where tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does exceed a sum of rupees three crore.

## **4. What is impermissible avoidance arrangement?**

The phrase 'impermissible avoidance arrangement' has been defined under section 96(1) of the Act. For a transaction to be declared 'impermissible avoidance arrangement', it must satisfy below mentioned twin conditions cumulatively: –

**Condition 1:** The main purpose of the arrangement is to obtain a tax benefit (Main purpose test)

**Condition 2:**The arrangement should have one or more below mentioned specified tainted elements (Tainted element test) :-

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

(b) The arrangement results, directly or indirectly, in the misuse, or abuse, of the provisions of the Act;

The arrangement lacks commercial substance or is deemed to lack commercial substance under section 97 of the Act, in whole or in part;

(c) The arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

Section 96(2) of the Act makes a rebuttable presumption that an arrangement shall be presumed to have been entered for main purpose of obtaining tax benefit where main purpose of even a single step or of part of that arrangement, isto obtain a tax benefit, notwithstanding the fact that main purpose of whole arrangement is not to obtain tax benefit.

## **5. Arrangement lacking commercial substance**

Section 97(1) of the Act provides certain situations wherein an arrangement shall be deemed to lack commercial substance. These situations are:

(a) Where substance of the arrangement is inconsistent with, or differs significantly from its form.

Clause (a) of section 97(1) codifies the **doctrine of substance over form**. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the 'substance' of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

(b) If the arrangement involves –

(i) Round Trip Financing

Section 97(2) of the Act defines round trip financing to include any arrangement in which, through a series of transactions, funds are transferred among the parties to the arrangement and such transactions do not have any substantial commercial purpose other than obtaining the tax benefit.

(ii) An accommodating party

Section 97(3) of the Act defines an accommodating party to be a party which is included in an arrangement mainly for obtaining tax benefit to the taxpayer. Such party may or may not be a connected party to the taxpayer.

(iii) Elements that have effect of offsetting or cancelling each other

Item (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(iv) Transaction conducted through one or more persons which disguises the value, location, source, ownership or control of funds

Item (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance.

(c) Where arrangement involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose.

It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

(d) Where arrangement does not effect significantly the business risks or net cash flows of any party to the arrangement and only attributes tax benefits

Clause (d) of section 97(1) of the Act was inserted on recommendation of Dr. Shome Committee. It implies that besides having a commercial purpose, the taxpayer should also have commercial substance in the arrangement, which mean change in economic position of the taxpayer by altering the business risks or net cash flow to him.

## **6. Consequences of impermissible avoidance arrangement**

As per section 98(1), if an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence shall be determined, in such manner as is deemed appropriate, in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital nature or revenue nature; or

(ii) any expenditure, deduction, relief or rebate;

(f) treating—

(i) the place of residence of any party to the arrangement; or

(ii) the 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; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

## **7. Conclusion**

GAAR has already become effective from April 1, 2017. In this article, an attempt has been made to comprehend the legal aspects related to GAAR. Another equally important area deals with procedural aspects in implementation of GAAR. The procedural aspects of GAAR along with CBDT's clarifications through its Circular would be dealt by the author in second series of this article.

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