

Form & substance GAAR, Principle Purpose Test and unilateral treaty override

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GAAR & PPT

Methods of Reducing Tax Liability

Tax Evasion

- Unlawful and is the result of illegality, suppression, misrepresentation and fraud

Tax Avoidance

- Legal exploitation of tax laws to one's own advantage.

Tax Mitigation

- Legitimate claim of exemptions & deductions as per the provisions of the Act in accordance with the object and purpose of the Act and not misuse and abuse of the provisions (e.g. section 10, Chapter VI-A deductions, etc.)

Trigger of GAAR

□ Two cumulative conditions to trigger GAAR –

- Main purpose to avoid tax

+

- One of the four tainted elements
 - arm's length
 - misuse, or abuse of the provisions of this Act;
 - lacks commercial substance
 - bona fide

Trigger of GAAR

❑ Commercial Substance (S. 97)

- 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; or
- **round trip** financing;
- **accommodating party**;
- elements that have effect of **offsetting** or cancelling each other; or
- a transaction which is conducted through one or more persons and **disguises** the value, location, source, ownership or control of funds which is the subject matter of such transaction; or
- involves the **location** of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit; or
- does not have a significant effect upon the **business risks** or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit.

Trigger of GAAR

- ❑ Is enactment of statutory GAAR an end to judicial GAAR ?
 - Liberal trend – CIT v. A. Raman & Co., UOI v. Azadi Bachao Andolan, Duke of Westminster
 - Anti-avoidance trend – McDowell & Co. Ltd. v. CTO, Formula One World Championship Ltd. v. CIT

- ❑ GAAR excludes justifiable avoidance
 - Commercial purpose v. tax as main purpose
 - Existence of one out of four taints
 - CIT v. Provident Investment Co. Ltd. (32 ITR 190) (SC);
 - CIT v. Walfort Share & Stock Brokers (P.) Ltd. [2010] 326 ITR 1 (SC)

Preamble to DTAA & PPT

- ❑ The DTAA preamble text which is sought to be introduced / replaced by MLI reads as under:
 - *“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)”*

- ❑ Text of PPT
 - *“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, 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.”*

Preamble to DTAA & PPT

□ Preamble & PPT

- Part of BEPS minimum standard - majority of Indian treaties would incorporate the language – except few treaties where the treaty partner has not signed MLI or has not notified treaty with India to be modified through MLI e.g. US, Mauritius, Hongkong, Oman, Germany, China (treaty already modified though bilateral negotiation).

Dissecting the Article on PPT

☐ Limbs of Article on PPT

- Benefit under DTAA in respect of income or capital
- reasonable to conclude
- all relevant facts and circumstances
- tax benefit
- one of the main purpose
- of arrangement or transaction
- directly or indirectly
- **Unless benefit as per object and purpose of DTAA**

Highlights PPT – OECD Commentary on Article 29

- ❑ PPT Test – for each source of income and not entity wise
- ❑ The term ‘arrangement’ or ‘transaction’ needs broad interpretation - Para 177
- ❑ Intention of DTAA – to provide benefits in respect of **bona fide** exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment - Para 174
- ❑ Where an arrangement is **inextricably linked** to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit – PPT N.A. – Para 181
- ❑ Even where a transaction is designed to obtain benefits under multiple treaties, the PPT is likely to trigger – Para 181

GAAR & PPT – Similarities

□Arrangement

- GAAR - 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
- PPT (Para 177) - agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable.
 - In particular they include the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues.
 - These terms also encompass arrangements involving qualification of a person who derives the income, as a resident of one of the Contracting States {akin to accommodating party under GAAR}, and **include steps that persons may take themselves in order to establish residence.**
 - One transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit {Step or part of arrangement}.

GAAR & PPT – Similarities

Tax benefit

- GAAR - reduction or avoidance or deferral or refund of tax, reduction in income, increase in loss.
- PPT - tax reduction, exemption, deferral or refund – Para 175

Importance of purpose of arrangement

- GAAR – main purpose – but to be tested for even for step or part of an arrangement
- PPT – one of the main purposes of the arrangement
- GAAR – commercial purpose achieved in tax efficient manner may not trigger GAAR (FAQ No. 3)
- PPT - benefit in these circumstances would be in accordance with the object and purpose of DTAA

What can be non–tax purpose

- Concession in indirect tax,
- Ease of obtaining internationally recognised licenses,
- ease of obtaining finance,
- Effective IPR protection laws,
- Better corporate governance
- Hedging political risk;
- Protection from legal liabilities;
- Mobility of investment;
- Facilitate an exit route;
- Promoting specialization;
- Operational efficiency (availability of good infrastructure, reasonable costs of operation)
- Availability of skilled, multi-lingual work force;

What can be non–tax purpose

- Availability of directors with knowledge of regional business practices and applicable regulations;
- Membership of a regional grouping, or, of a common currency area;
- Enable creditors to lend against specified investment or division; Creditors may not have to monitor performance of whole group; to limit information which creditor should have;
- Taking shelter under a bilateral trade agreement or investment protection agreement
- 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);
- FAQ 4 - GAAR shall not be invoked merely if the entity is located in tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations (PPT – Example K)**

Consequences of GAAR & PPT

□ GAAR (S. 98)

- **Denial of tax benefit (under treaty or the Act)**
- Disregarding/ combining /re-characterising any step in, or a part or whole of the arrangement
- Treating the arrangement as if it had not been entered into or carried out
- Disregarding any accommodating party/connected person or treating any accommodating party/connected person and any other party as one and the same person
- Reallocating income, expense, deduction, relief, rebate amongst the parties to the arrangement

Consequences of GAAR & PPT

❑ GAAR (S. 98) (cont . . .)

- Re-assign place of residence/ situs of asset or transaction
- Disregarding the corporate structure (“look through”)
- Re-characterize equity-debt, capital receipt – revenue receipt and any expenses, deduction, relief, rebate
- Inclusive definition – not limited to the aforesaid consequences

❑ PPT

- Denial of treaty benefit

GAAR – PPT – Exemption

- ❑ An arrangement where the tax benefit in the **particular year** arising, in aggregate, to **all the parties** to the arrangement less than **Rs. 3 crore**
 - FAQ 14 – Net basis (?) – but only considering tax payable in India.
- ❑ 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.
- ❑ Foreign Institutional Investor —
 - (i) who is an assessee under the Act;
 - (ii) who has not taken benefit of DTAA; and
 - (iii) who has invested in listed securities, or unlisted securities.
- ❑ A non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor.
- ❑ **PPT no specific exemption – no de minimus but, would PPT apply to investments made before introduction of PPT. Also, is benefit to FII/FPI as per object and purpose of Treaty**

GAAR – Implementation safeguard

❑ GAAR – Safeguard – 3 stage hearing

- Tax Officer

- PCIT/CIT

- Approving Panel

 - Constitution of Approving Panel – 3 Members – Retired/ present HC judge, IRS not below PCIT/ CCIT and academic/ scholar

❑ PPT no specific exemption (even optional clause not included by India – optionality clause gave power to the tax authority to grant DTAA benefit even in if PPT is not satisfied)

- States may wish to establish a administrative process that would ensure that paragraph 9 is only applied after approval at a senior level within the administration. (Para 183 of OECD Commentary on Article 29)

OECD Examples on PPT

- ❑ Example C Selection of a jurisdiction out of three jurisdiction to set-up manufacturing facility because the jurisdiction has tax treaty. OECD View – Treaty benefit would be available (GAAR FAQ 3).
- ❑ Example D Decision of Collective Investment Vehicle in a treaty friendly jurisdiction by itself will not trigger PPT (GAAR – no tainted element).
- ❑ Example G – Regional Headquarter– Management Services such as accounting, legal advice and human resources; financing and treasury services. Benefit – Skilled labour force; reliable legal system; business friendly environment; etc. Jurisdiction chosen after considering treaty benefit with investee jurisdiction.
 - OECD View – Treaty benefit would be available (GAAR – main purpose not tax, no taint)
- ❑ Example H –Investment through subsidiary - Benefit – Human and financial resources (in various areas such as legal, financial, accounting, taxation, risk management, auditing and internal control)
 - OECD View - In absence of other facts that would indicate that one of the principal purposes for the establishment of SPV was for obtaining of the benefits of the treaty paragraph 9 would not apply to these transactions (GAAR – main purpose, no taint).

Examples – Examples on PPT

- ❑ Example E – Genuine increase in % of shareholding from 24% to 25% to be entitled to concessional rate of dividend.
 - In view of OECD, this is in accordance with object and purpose of specific provision of treaty which arbitrarily fixed eligibility criteria at 25% and the taxpayer genuinely met such qualification criterion.
- ❑ Example J Splitting of construction contract between holding and newly formed subsidiary company to avoid crossing time threshold which would trigger PE.
 - If inter-positioning of subsidiary is not for substantial commercial purposes, the arrangement is not considered by OECD to be in accordance with object and purpose of specific provision of treaty.
- ❑ Example A – Investor routed his investment in Operating Company through the Holding Company of the operating company to reduce withholding tax on dividend. Investor acquired preferred shares of Holding Company – entitled Investor to 3.75% dividend and 20% profits of operating company. The Holding Company utilized the proceeds from the investor to acquire preferred shares of the operating company which entitled Holding Company to 4% dividend and 20% profits of operating company.
 - OECD – One of the main purpose of Holding Company participating in the transaction was to achieve reduction of tax – PPT will apply.

Practical issues – PPT & GAAR

- ❑ If GAAR is not applicable because of grandfathering – whether PPT can apply ?
- ❑ Is a treaty signed before introduction of GAAR is grandfathered from application of GAAR ?
 - Does it amount to unilateral modification ?
 - Static approach v. ambulatory approach
- ❑ Whether PPT will apply to arrangement entered prior to the modification of DTAA ?
 - Timken India Ltd vs. CIT [2002] 256 ITR 460 (Cal HC)
 - Tata Iron and Sons vs. Deputy CIT [1999] 69 ITD 292 (Mum. Trib)
- ❑ Whether GAAR & PPT to be considered by the deductor at the time of withholding tax on payment to non-resident u/s 195 ?

Practical issues – PPT & GAAR

- ❑ PPT & GAAR will apply even to step or part of the arrangement ?
 - GAAR – Yes – Section 96(2)
 - PPT ?
 - Text – ‘all facts and circumstances’
 - Para 177 of OECD Commentary on Article 29

- ❑ Whether OECD Examples on PPT can be applied for interpretation of GAAR ?
 - Main Purpose v. One of the principal purpose
 - No reservation is expressed by India on the examples

Unilateral Treaty Override

Some on-going controversies in India

Whether DTAA will apply to dividend distribution tax payable u/s 115-O ?

- Issue pending before various tribunals
- UOI v. Tata Tea Co. Ltd. [2017] 85 taxmann.com 346 (SC) – S. 115-O levies a tax on dividend. Language of DTAA restricts tax on dividend paid to resident of Contracting State – does not specify the assessee liable to pay tax on dividend paid to resident of Contracting State
- Whether a country can circumvent DTAA by simply changing the person being taxed (i.e. in this case company instead of shareholder) ?

May be taxed

- CIT v. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)
- Notification No. 90/2008, Dated 28-8-2008
- Essar Oil Ltd. v. ACIT [2013] 157 TTJ 785 (Mumbai - Trib.)
- Excessive delegation ?

GAAR v. DTAA

- S. 90(2A) provides that the provisions of GAAR should apply to the taxpayer even if such provisions are not beneficial.
- Article 26 of Vienna Convention – Every treaty in force is binding upon the parties to it and must be performed by them in good faith
- Article 51 of Constitution of India – The State shall endeavour to:
 - (c) Foster respect for international law and treaty obligation in the dealings of organized peoples with one another*
- Domestic Anti Abuse v. DTAA - *it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into. – Para 60 of OECD Commentary on Article 1*

GAAR v. DTAA – specifically permitted by DTAA

- ❑ Bhutan, Columbia, Ethiopia, Fiji, Kazakhstan, Kenya, Malaysia, Thailand, Uzbekistan
 - *The provisions of this Agreement shall in no case prevent a Contracting State from the application of the provisions of its domestic law and measures concerning tax avoidance or evasion, whether or not described as such.*

- ❑ Estonia, Georgia, Israel, Luxembourg, Macedonia, Malta, Uruguay
 - *Nothing in this Agreement shall affect the application of the domestic provisions to prevent tax evasion.*

- ❑ Spain
 - *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.*

GAAR v. DTAA

❑ Whether GAAR can override DTAA ?

- **FAQ 9** –Admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR.
- **FAQ 2** – LOB Clause in the treaty – 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 **sufficiently addressed** by LOB in the treaty, there shall not be an occasion to invoke GAAR.
 - Contrary to Committee Recommendations – Where anti-avoidance rules are provided in a tax treaty in the form of limitation of benefit (as in the Singapore treaty) etc., the GAAR provisions shall not apply overriding the treaty.
- OECD – Domestic anti-abuse may override DTAA – Para 57 – 80 – OECD Commentary on Article 1

GAAR & PPT v. SAAR

❑ Circular FAQ 1 – “Will GAAR be invoked if SAAR applies?”

*It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. **The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.**” – Contrary Committee Report*

❑ "Statement of the Finance Minister on GAAR - Press Release, Dated 14-1-2013"

- *"7. The major recommendations of the Expert Committee have been accepted, with some modifications, and the following decisions have been taken by Government:. . . (xiii) Where GAAR and SAAR are both in force, only one of them will apply to a given case, and guidelines will be made regarding the applicability of one or the other."*

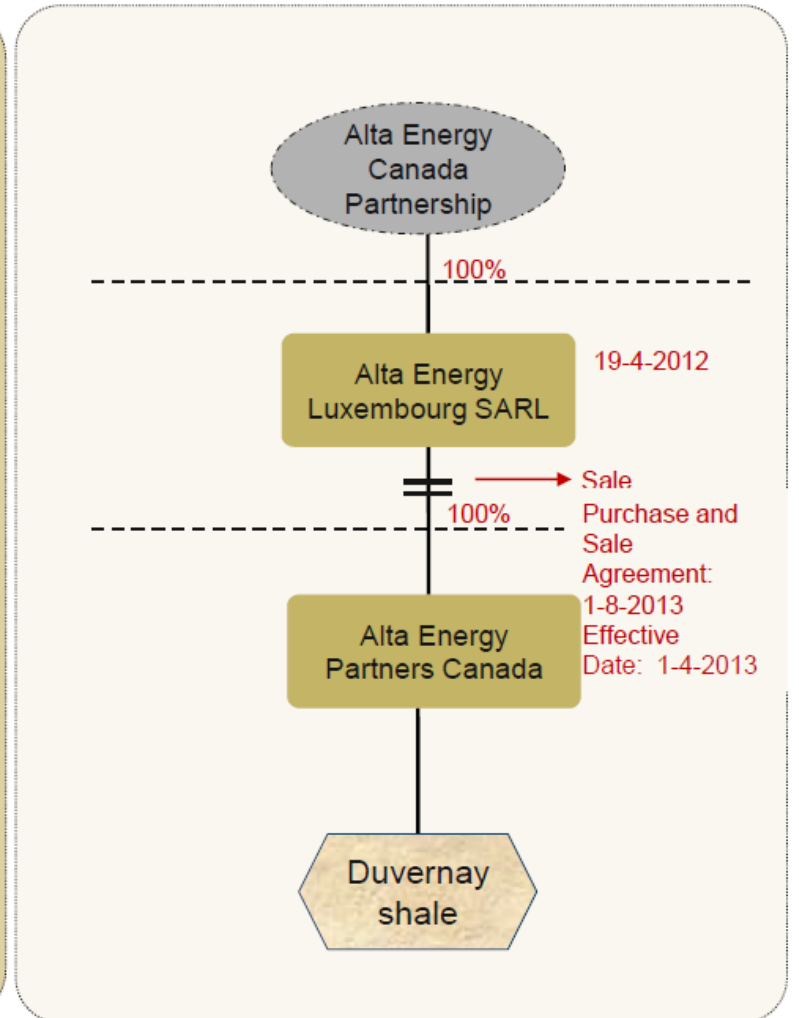
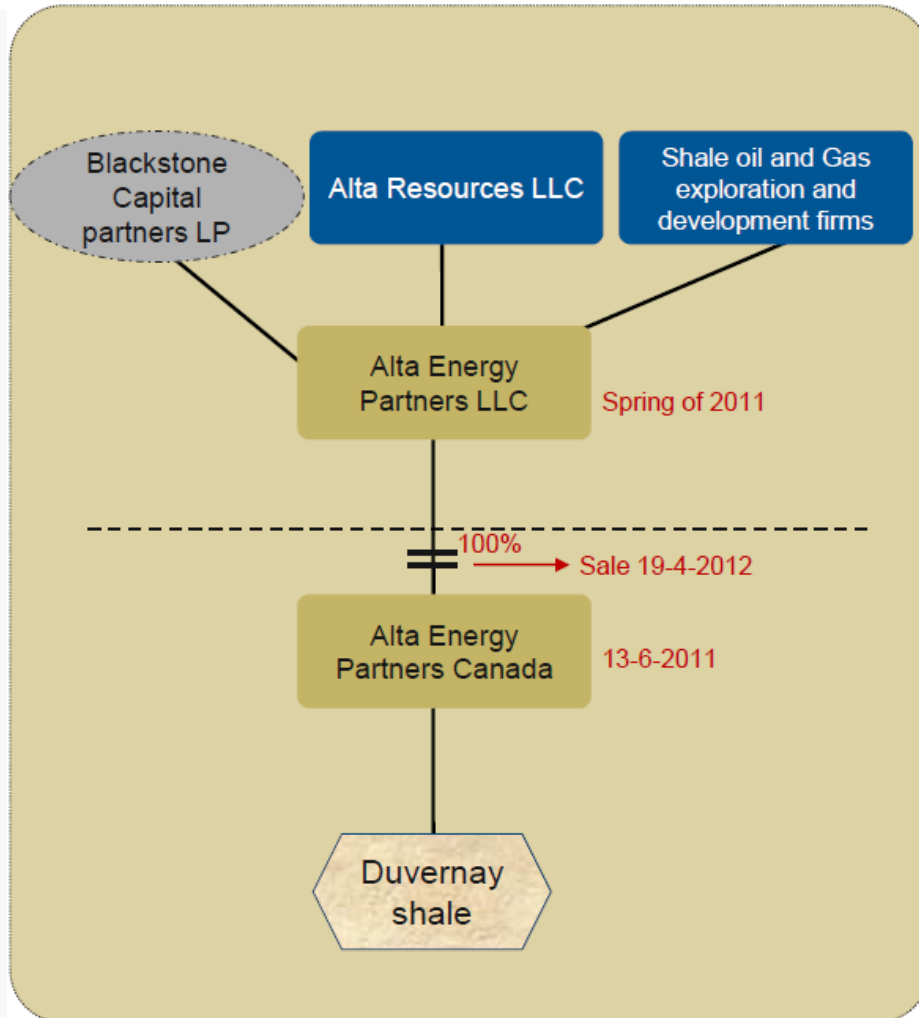
GAAR & PPT v. SAAR

- ❑ *PPT does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance – Para 62 of OECD Commentary on Article 1*

- ❑ GAAR v. SAAR – Bowman A.C.J. in the Canadian case *Geransky vs The Queen* [2001] 2 CTC 2147 {Affirmed by Federal Court of Canada} at Paragraph 42:
 - *"The Income-tax Act is a statute that is remarkable for its specificity and replete with anti-avoidance provisions designed to counteract specific perceived abuses. Where a taxpayer applies those provisions and manages to avoid the pitfalls the Minister cannot say **"Because you have avoided the shoals and traps of the Act and have not carried out your commercial transaction in a manner that maximizes your tax, I will use GAAR to fill in any gaps not covered by the multitude of specific anti-avoidance provisions"***

International Judicial Precedents

Alta Energy Luxembourg SARL (2018 TCC 152)



Summary Core Issue and Court Decision

☐ 1st issue

- Is Duvernay shale excluded property? Court : yes
 - DTAA – source country has the right to tax capital gains from alienation of shares deriving their value from immovable property – **except where in the immovable property is used for the business of the tax payer (carve out not in OECD Model Convention).**
 - Purpose of the carve out is to attract foreign direct investment (FDI) Alta's exploration, drilling and extraction activities are in accordance with industry practice

☐ 2nd issue

- Is the domestic GAAR applicable? Court : No
 - Restructuring's primary purpose is to obtain a tax benefit
 - But is it abusive?
 - Object and purpose: attract FDI treaty negotiators were aware of Luxembourg participation exemption, nonetheless they departed from OECD Model. Court declined to intervene in this bargain

FCT v Futuris and RCI Pty Ltd (Australian Court)

- ❑ The taxpayers came up with an ingenious argument - that they had not obtained any tax benefits. The argument went that had they not entered into the arrangement, they would have entered into alternative arrangements that either had:
 - 1. Similar tax results (so no significant increase or decrease), or
 - 2. Higher tax benefits (so the actual arrangement entered into yielded a tax disadvantage for them), or
 - 3. Would not have entered into the arrangement in the first place because the tax consequences were too prohibitive. This is known as the “do nothing” argument.

- ❑ Tax payers argument –
 - The alternative mechanism proposed by Department involved double taxation, it would have done nothing (i.e. not gone ahead with the transaction).
 - The tax cost would have been too much to make the transaction commercially viable and it was not a reasonable alternative that Futuris' directors would have committed to. Futuris would have simply held on to its business.

FCT v Futuris and RCI Pty Ltd (Australian Court)

- ❑ The Australian Federal Court accepted this argument and held that a tax benefit had not been obtained. The Commissioner's alternative hypothesis was unreasonable. Futuris would have adopted a different course of action or done nothing at all.

- ❑ Takeaway - The alternative postulate must be reasonably construed in light of commercial considerations.

- ❑ Relevance to India (?) – Case like Ajanta Pharma – department invoked GAAR on reverse merger of shareholder company into the operating company
 - Capital Gains Tax + Dividend Distribution Tax – erodes more than 50% of the wealth

 - The tax payer would have opted for the option of doing nothing.

Simplified Limitation of Benefit

MLI – Simplified Limitation of Benefit

- ❑ Qualified person Art. 7 Para. 9
 - a. An individual
 - b. A Contracting jurisdiction and components thereof
 - c. A company quoted on a recognized stock exchange and affiliates thereof
 - d. i) a non profit organization agreed upon;
 - ii) a regulated pension fund
 - e. An entity if owned (in)directly at least for 50% by persons under a to d
- ❑ Active conduct of a business Art. 7 Para. 10 holding activities, supervision and administration, group financing, investment management activities are excluded; connected persons' activities are included
- ❑ Derivative benefits test Art. 7 Para. 11 at least 75% is (in)directly owned by equivalent beneficiaries (“equivalent to, or more favourable than”)
- ❑ Competent Authority to grant the benefit Art. 7 Para. 12

MLI – Simplified Limitation of Benefit Clause

❑ Applicability of SLOB

- SLOB and PPT will have simultaneous application – Para 171 to 173 of OECD Commentary on Article 29
- India has opted for SLOB
- Out of 89 countries that had ratified MLI by mid 2019, only 19 countries have opted for SLOB.
- Presently, SLOB will only apply to India-Russia DTAA and India-Greece (asymmetrical application – only India to apply to Greece Resident).
- Conclusion – SLOB does not apply to majority of Indian Tax Treaties

Thank You