17TH BCAS DTAA CERTIFICATE COURSE
SUBSTANCE VS FORM

By Sunil Moti Lala*
Advocate & Tax Counsel
SML tax chamber
www.smltaxchamber.com
*Assisted by CA Prerna Peshori & Tushar Hathiramani

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INTRODUCTION

Introduction

Assessee

Relative of assessee

Relative of assessee

Company C

98%

Balance 2%

B Ltd (listed on stock exchange)

Transfer of shares – STT paid, therefore exempt u/s 10(38)

Transfer of property effected through transfer of shares – no capital gains tax / stamp duty

In Form, shares are transferred, but in substance, property has been transferred

JURISPRUDENCE ON FORM & SUBSTANCE

Foreign Decisions
Where Form Was Upheld

- IRC v Fleming & Co

Facts:	Judgment
• The compensation for the termination of agency of £6,700 was granted to assessee which was bifurcated into three parts: i. Loss of agency - £5,320 ii.Non-compete - £590 iii.Transfer of goods in use by assessee - £800 • Assessee had treated all the three as capital receipt. • The revenue accepted that (ii) and (iii) were capital in nature but contended that amount received towards **loss of agency** was revenue receipt considering the fact that the assessee was holding a total of eight agencies and therefore the loss concerning only one of such agencies represented **normal trading risk**.	• **The Court ruled in favour of the Revenue** and held that in the instant case, the substance of the transaction could not be easily equated with the formal deed by which the transaction received effect. It noted that if attention was concentrated upon the business substance of the transaction, the payment would be treated as capital payment, not taxable, but if attention was upon the form, the payment ought to have been treated as revenue. **It held that since the parties had covenanted in a particular form for three distinct considerations, it was not permissible to ignore the legal effect of the documents entered into. Therefore, it held that it was not legitimate to look behind the form. Accordingly, it held that the compensation for loss of agency was revenue in nature.**

Foreign Decisions
Where Form Was Upheld

- Saunders v Pilcher

Facts:	**Judgment**
• Assessee had purchased land with fruit bearing trees viz. cherry trees for which had paid lump-sum consideration i.e.£5,500. • Subsequently, the assessee sold the cherries obtained at £2,903 and sought to deduct a sum of £2,500 as cost of cherries while computing its trade profits	• The Court held that purchase of the growing crops was part of a transaction for the purchase of a capital asset, the land and the trees, and therefore, the price paid for the crop was not a sum which could be deducted in computing the profits or gains

Foreign Decisions
Where Form Was Upheld

- Pott's Executors v IRC

Facts:

- A settlor made a settlement for various objects and beneficiaries and had a current account with the trustees of the settlement.
- In that current account, he was debited with the sums which were paid on his behalf by the trustees in discharge of his income-tax liabilities
- The Inland Revenue Commissioners held that the payments made by the trustees was to be treated as a loan under section 408 of the UK Income-tax Act, 1952, as per which capital sums paid to a settlor would be taxed as income of the settlor to the extent that the sum fell within the amount of income available to the trust up to the end of the year

Judgment

- The Court held that there was no payment of loan

Foreign Decisions
Where Form Was Upheld

- Duke of Westminister case

Facts:

- In this case, Duke of Westminister entered into an agreement by which he stopped paying a non-deductible wage to his Gardener and instead drew up a covenant agreeing to pay an equivalent amount, which if correctly characterized as annuities would be tax deductible.
- The Gardener still received the same amount in wages but the Duke gained a tax benefit - Under the applicable law, if the amounts paid were remuneration for services, they were not deductible in computing the Duke's liability for surtax. If, on the other hand, the amounts were annual payments, they were deductible, the covenant resulted in reduction of liability.

Judgment

- "Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

Foreign Decisions
Where Form Was Upheld

- Duke of Westminister case

Comment: This landmark decision provided legitimacy to tax planning even if its sole motive was to save tax. In substance this judgment indicated that legal form would govern the tax consequences and that the tax payer could arrange his affairs for tax savings.

Indian Decisions Where Form Was Upheld

- Provident Investment Co Ltd v CIT (1957) 32 ITR 190 (SC)

Facts:

- The assessee-company was the managing agent of 'M' and 'S' companies. The assessee held majority of conversion shares of those companies. 'D' company wrote a letter to the assessee mentioning that it wanted to purchase conversion shares of 'M' and 'S' companies with along with the managing agency (for Rs. 1 crore), which was accepted by the board of directors of the assessee.
- Subsequently, D company wrote a letter to the assessee asking it to relinquish its rights in the managing agency by resigning i.e. without transferring it to D.
- ITO treated the consideration as consideration on transfer of the managing agency and therefore brought the alleged profits or gains arising to tax under income from capital gains, which had been upheld by the Tribunal. The High Court however held that there was neither a sale nor a transfer of the managing agency.

Judgment

- The Apex Court observed that *"the High Court, thus, correctly held that whereas under the original contract the 'D' company wanted the managing agency to be transferred, which meant that it wanted the benefit of that contract to be vested in it and was also prepared to accept the burden of the obligations that went with that contract, under the substituted contract, the 'D' Company did not want the managing agency to be assigned to it; on the contrary, it wanted the assessee-company to relinquish its rights in the managing agency of the two mills by resigning. On a true interpretation, the letter written by 'D' company-substituted a new contract, a contract of relinquishment rather than a contract of sale, so far as the managing agency was concerned.*
- *Thus, the transaction in its true legal character was a relinquishment of the managing agency and was neither a sale nor a transfer thereof. Consequently, the High Court correctly held that the assessee-company did not make capital gain within meaning of section 12B of the 1922 Act."*

Indian Decisions Where Form Was Upheld

- **CIT v Punjab State Electricity Board - 320 ITR 469 (Punjab & Haryana)**
  Merely because tax liability was reduced could not be conclusive of arrangement being sham or a device – Assessee was therefore entitled to depreciation and no substantial question of law arises.

- **Banyan & Berry v CIT - 222 ITR 831 (Guj)**
  Every legitimate and genuine act on the part of the taxpayer resulting in reduction of tax liability cannot be treated as device for avoidance of tax.

- **Industrial Development Corporation of Orissa Ltd v CIT - 268 ITR 130 (Orissa)**
  An act which is otherwise valid in law cannot be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests.

- **CIT v George Williamson (Assam)Ltd - 265 ITR 626 (Gau)**
  It is open for assesses to arrange their affairs in such a manner that it would not attract the tax liabilities

- **CIT v Mrs. Sarita P Shirke & Anr - 280 ITR 325 (Bom)**
  In any case, even otherwise if a person is entitled to an exemption in law and he accordingly makes a plan for avoiding the tax liability which is otherwise legally entitled to it would not amount to a tax evasion.

Decisions Where Substance Was Upheld

- Ramsay Ltd (WT) v IRC (1981) 1 ALL ER 865 (HL)

Facts:

- **The tax payer made a large capital gain on the sale of farm.** This gain it desired to counteract, **so as to avoid the tax**, by establishing an allowable loss. To offset this **he entered into a series of separate share and loan transactions** which generated both a non-taxable gain and fully allowable loss. The multi-step transaction as a whole was circular and self cancelling. The tax payer hence began and ended in the same financial position **and still claimed a tax loss. The House of Lords disallowed the loss as fiscal nullity as the tax payer had not incurred any real financial loss.**

Judgment

- "Where a taxpayer used a scheme comprising a number of separate transactions with the object of avoiding tax, the Revenue and the Courts were not limited to considering the genuineness or otherwise of each individual step or transaction in the scheme, but could consider the scheme as a whole and if was found that the composite transaction produced neither a gain or a loss, it could be treated as a nullity for tax purposes.."

Decisions Where Substance Was Upheld

- Ramsay Ltd (WT) v IRC

  Comment:

  This decision was significant departure from Westminister case. **In this case, House of Lords had to consider a scheme of tax avoidance which consisted of a series or a combination of transactions each of which was individually genuine but the result of all of which was avoidance of tax.** The true principle of the decision in Ramsay was that the fiscal consequence of a preordained series of transaction is generally to be ascertained by considering the result of the series as a whole and not by dissecting the scheme and considering the whole transaction separately.

Decisions Where Substance Was Upheld

- Wood Polymer Ltd (1977) 109 ITR 177 (Guj)

Facts:

- The assessee, the transferee, had entered to a scheme of amalgamation with Bengal Hotels Pvt Ltd (the transferor) which was merely created to facilitate the transfer of immovable property belonging to the transferor's parents company to the assessee so as to avoid capital gains tax by availing benefit under section 47 of the Act, which would have otherwise been payable under section 45 of the Act.
- The assessee approached the Hon'ble High Court for grant of sanction of the scheme of amalgamation under the Companies Act, 1956

Judgment

- It is open to a party to so as to arrange its affairs so as to reduce tax liability….but it must be within the power of the party to arrange its affairs. If the party seeks the assistance of the Court to reduce its tax liability the Court should be the last instrument to grant such assistance or judicial process to defeat a tax liability.

Decisions Where Substance Was Upheld

- Wood Polymer Ltd (1977) 109 ITR 177 (Guj)

Comment: If a device, in this case incorporation of transferor company, is used for a illegal, improper or fraudulent purpose the corporate veil may be lifted i.e. substance would be upheld.

Mcdowell & Co Ltd v Commercial Tax Officer – (1985) 154 ITR 148 (SC)

Facts:

- Under the A.P. Excise Act and Rules, a manufacturer could remove liquor from the distillery only upon payment of excise duty. However, the buyers of liquor from the assessee themselves paid the excise duty before the removal of the goods without the assessee showing the duty as price received by it from the buyer.
- The assessee continued to sell liquor in this manner and paid sales tax under the A.P. Sales Tax Act on the turnover returned by him which did not, as mentioned, include the amount of the excise duty.
- Subsequently, the Commercial Tax Officer sought to reopen the said assessment as the appellant had failed to include the excise duty paid on the liquor sold by it to wholesalers.
- The sales tax authorities issued a notice to the appellant proposing to include a certain sum representing excise duty paid directly by the buyers of appellant's liquor in the appellant's turnover for a part of the year
- The High Court held that excise duty which was payable by the appellant but had by amicable arrangement been paid by the buyer was actually a part of the turnover of the appellant and was, therefore, liable to be so included for determining liability for sales tax.

Mcdowell & Co Ltd v Commercial Tax Officer – (1985) 154 ITR 148 (SC)

Judgment:-

We think that time has come for us to depart from the Westminster principle … In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it.

…**the tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by restoring to dubious methods**. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges. Courts are now concerning themselves not merely with the genuineness of a transaction, but with the intended effect of it for fiscal purposes. No one can now get away with a tax avoidance project with the mere statement that there is nothing illegal about it.

Union of India v Azadi Bachao Andolan – (2003) 263 ITR 706 (SC)

Facts:-

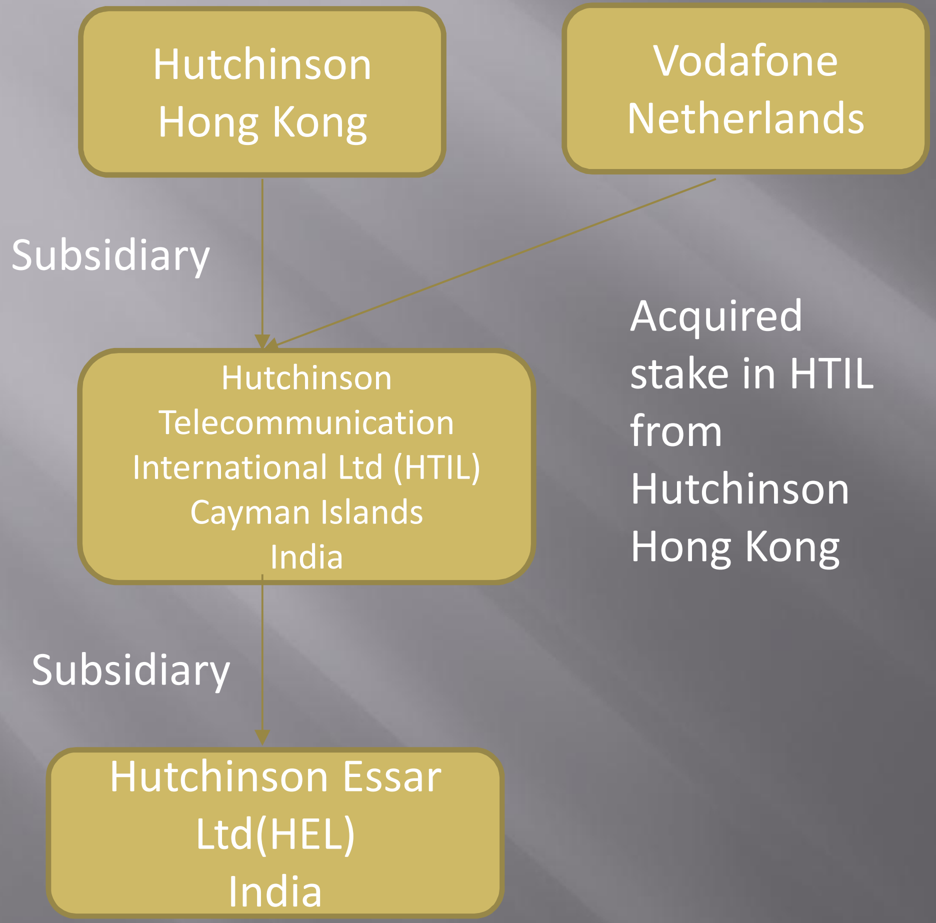
- This judgment was in the context of eligibility of treaty benefits to Foreign Investors who routed their investment to India through Mauritius. The Indian tax authorities denied tax treaty benefits on the ground that such foreign investors were controlled and managed from countries other than India and Mauritius and were misusing the India Mauritius DTAA.
- **By Circular No. 682** dated 30.3.1994 issued by the CBDT in exercise of its powers under section 90 of the Act, the **Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius**
- Later, **CBDT issued Circular No. 789**, dated 13-4-2000 **clarifying that FIIs, etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares**.
- **Further, it clarified that TRC issued by the Mauritian Authorities will constitute sufficient evidence** for accepting **the status of residence** as well as **beneficial ownership** for applying the DTAC

Union of India v Azadi Bachao Andolan – (2003) 263 ITR 706 (SC)

Judgment:-

- Validity of circular no . 789 was upheld
- TRC issued by Mauritius authority was to be taken as conclusive evidence of residency
- The Apex Court observed that it cannot be said that its decision in McDowell's case can be read as laying down that every attempt at tax planning is illegitimate and must be ignored.

Vodafone International Holdings BV v Union of India – (2012) 341 ITR 1 (SC)



Facts:-

- The issue came up for consideration was as to whether aforesaid transfer could be termed as indirect transfer of a capital asset situate in India and whether section 9(1)(*i*) would be attracted in such a case and consequently whether capital gain arising from such transactions could be taxed in India.
- The High Court held that Vodafone on purchase of HTIL got indirect interest in HEL, acquired controlling right in certain indirect holding companies of HEL

Vodafone International Holdings BV v Union of India – (2012) 341 ITR 1 (SC)

Judgement:-

- **The Apex Court ruled in favour of the assessee** and rejected the conclusions arrived by High Court that *the sale of shares by HTIL to Vodafone would amount to transfer of a capital asset within the meaning of section 2(14) and the rights and entitlements form integral part of the shares attracting capital gains tax, cannot be accepted.* However, it made the following observations:

- No conflict between Azadi Bachao Andolan and Mcdowell

- **Genuine strategic planning is allowed unless it is sham.**

- Substance shall prevail over form

- "…if an actual controlling Non-Resident Enterprise (NRE) makes an indirect transfer through *"abuse of organisation form/legal form and without reasonable business purpose" which results in tax avoidance or avoidance of withholding tax, then the Revenue may disregard the form of the arrangement* or the impugned action through use of Non-Resident Holding Company, recharacterize the equity transfer according to its economic substance and impose the tax on the actual controlling Non-Resident Enterprise. Thus, *whether a transaction is used principally as a colourable device* for the distribution of earnings, profits and gains, **is determined by a review of all the facts** and circumstances surrounding the transaction. It is in the above cases that the *principle of lifting the corporate veil or the doctrine of substance over form or the concept of beneficial ownership or the concept of alter ego arises.* "

Vodafone International Holdings BV v Union of India – (2012) 341 ITR 1 (SC)

- "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*"

- In case of round tripping of funds

- "*Once the transaction is shown to be fraudulent, sham, circuitous or a device designed to defeat the interests of the shareholders, investors, parties to the contract and also for tax evasion, the Court can always lift the corporate veil and examine the substance of the transaction.*"

Vodafone International Holdings BV v Union of India – (2012) 341 ITR 1 (SC)

- *"<u>Lifting the corporate veil doctrine can, therefore, be applied in tax matters even in absence of any statutory authorisation to that effect</u>. Principle is also being applied in cases of holding company - subsidiary relationship- where in spite of being separate legal personalities, if the facts reveal that they indulge in dubious methods for tax evasion"*

- Revenue needs to establish abuse and can invoke substance over form principle only after it establishes that transaction is sham or tax avoidant

- **True nature to be ascertained by 'looking at' legal arrangement actually entered into and carried out. The question of providing 'look through' or 'Limitation of Benefit' in the statute or in the tax treaty is a matter of policy and has to be expressly provided for in the statute/tax treaty and cannot be read into by interpretation**

Vodafone International Holdings BV v Union of India – (2012) 341 ITR 1 (SC)

- *"Limitation of Benefits (LOB) clause and look through provisions cannot be read into treaty…."*
- In absence of LOB clause in treaty and in light of circular 789 and TRC certificate, tax department cannot at the time of divestment deny treaty benefit.
- *"<u>DTAA and Circular 789 would not preclude the Income-tax Department from denying the tax treaty benefits</u>, if it is established, on facts, that the <u>Mauritius company has been interposed</u> as the owner of the shares in India, at the time of disposal of the shares to a third party, <u>solely with a view to avoid tax without any commercial substance</u>… it is open to the Tax Department to discard the device and take into consideration the real transaction between the parties, and the transaction may be subjected to tax"*

SPECIFIC ANTI-AVOIDANCE RULES

Specific Anti-Avoidance Rules

- The limitation of benefits clause in the Double Tax Avoidance Agreements ('DTAA') and the concept of Controlled Foreign Corporations which combats the deferral of tax by allowing the country in which the controlling parent is resident to tax income accruing to the controlled corporation even before it is distributed.
- Section 2(22)(e), which in effect examines the substance of the transaction over its legal form;
- Section 9 of the Act which provides for instances where income is deemed to accrue or arise in India
- Section 14A of the Act preventing the assessee from claiming an expenditure in relation to income which is exempt under the provisions of the Act.
- Section 36(1)(ii) of the Act, which does not allow the payment of bonus to employees where such bonus was paid as profit or dividend
- Section 40(a)(i), 40(a)(ia), 40(a)(iii) disallowing payments on which tax due was not deducted
- Section 40b of the Act, disallowing interest and other expenses incurred by a firm unless the conditions prescribed in the section are fulfilled.

Specific Anti-Avoidance Rules

- Section 40A(2) and 40A(3) disallowing excessive amounts paid to related / interested parties and disallowing expenses paid in cash where in excess of Rs.20,000, respectively.
- Section 43(1) of the Act, which overlooks the mere legal form and determines the actual cost of assets
- Transfer of income without the transfer of assets under Section 60 of the Act
- Clubbing provisions contained in Section 64 of the Act
- Section 68, 69 etc which requires the assessee to prove the genuineness of transactions undertaken by it.
- The Transfer Pricing provisions.
- Section 94(7) of the Act introducing the concept of dividend stripping to prevent avoidance of tax by certain transactions in securities
- Section 179 of the Act prescribing the liability of directors of a private company in liquidation

PLACE OF EFFECTIVE MANAGEMENT (POEM)

Place of Effective Management (POEM)

- Sec 6(3) of ITA – A company is resident in India if it is an Indian Company or its POEM is in India

  Explanation: "Place of effective management means Place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, **in substance made."**

- **The press release dated 24th January, 2017** states that intent is to target shell companies and companies which are created for retaining income outside India although real control & management of affairs located in India

- The final guidelines issued by CBDT states that:
  - The place where these management decisions are taken would be more important than the place where such decisions are implemented. **For the purpose of determination of POEM it is the substance which would be conclusive rather than the form**

Place of Effective Management (POEM)

- Place **<u>where in in substance</u>**, BOD makes the key management and commercial decisions necessary for the conduct of the company's business as a whole

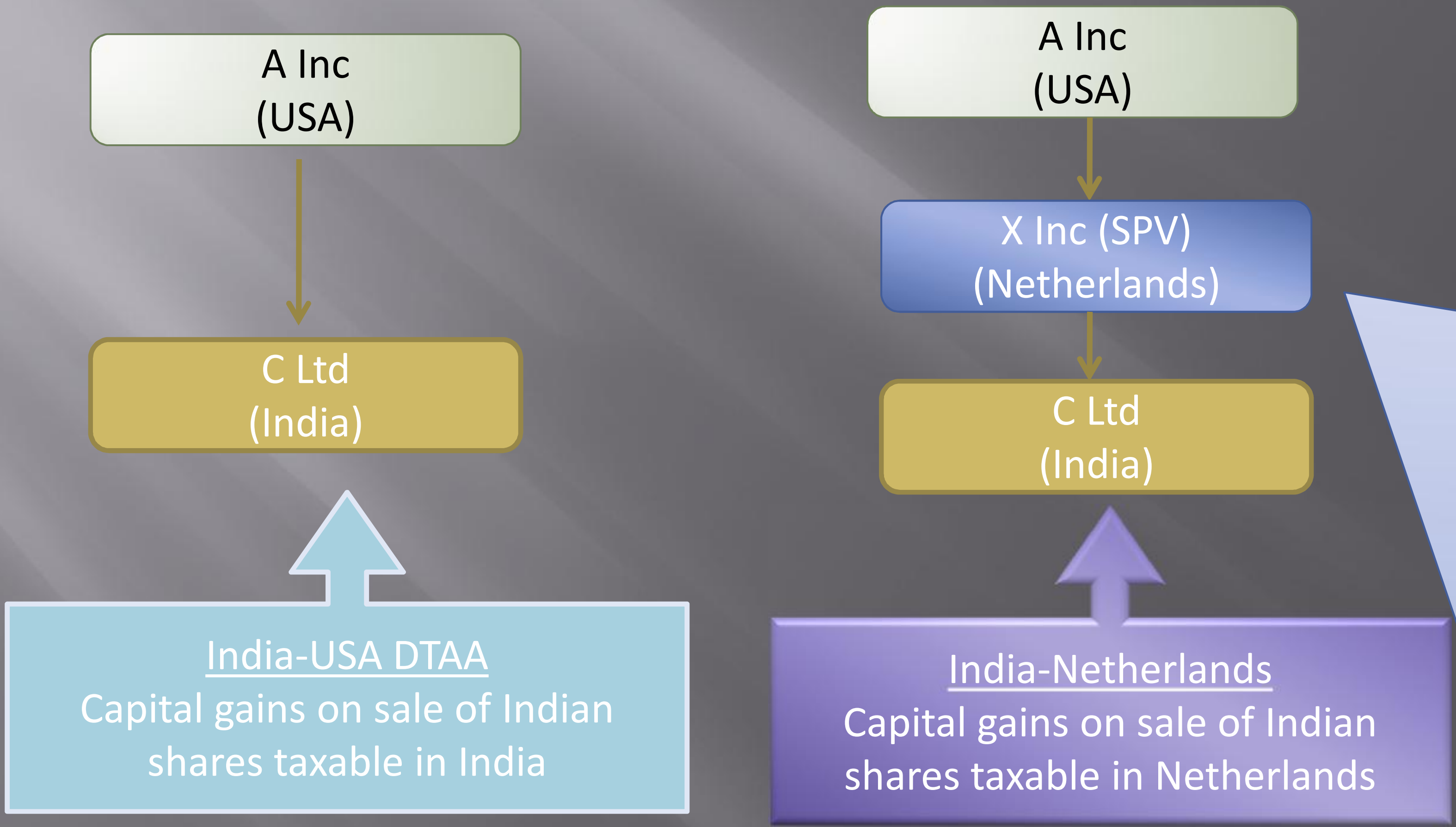
- **<u>Mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM</u>** being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM

- If BOD has delegated authority to senior management or executive committee or shareholders, POEM will be place where these person make decisions

TREATY SHOPPING, LIMITATION OF BENEFIT & BENEFICIAL OWNERSHIP

Treaty shopping

A Inc (company incorporated in USA) intends to invest in Indian shares and earn income by way of capital gains and dividend.



Treaty shopping' is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States (Azadi Bachao Case)

Limitation Of Benefit

- This may be considered as SAAR approach against treaty shopping.
- LOB clause is specifically designed to deal with "treaty shopping". This is also a provision which limits the use of treaties by the residents by planning restrictions.
- In these provisions, conditions are specified which limit the use of the treaty benefits between the residents of either of the contracting states. The residents of third countries are not allowed to use the bilateral convention between two states.
- This clause lays down conditions such as
  - Ownership test, (India-USA)
  - Minimum expenditure test
    - India-Mauritius- INR Rs.27,00,000/ Mauritian Rs. 15,00,000
    - India-Singapore - annual expenditure on operations in that Contracting State is equal to or more than S$200,000 in Singapore or Indian Rs.5,000,000 in India,
  - Active business connection test, (India-USA)
  - Recognized stock exchange test. (India-USA, Mauritius, Singapore)

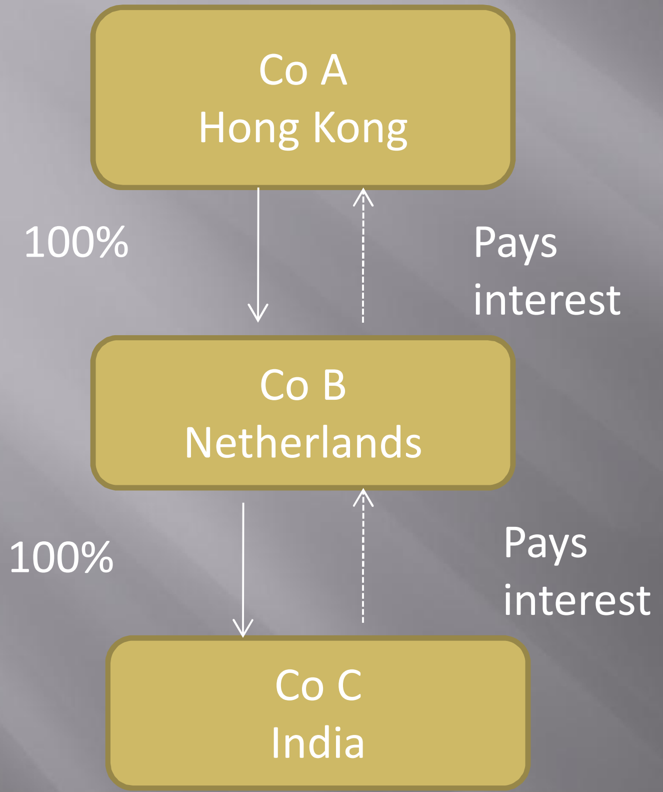
Limitation Of benefit

- LOB clause is present in following Indian DTAA
  - Revised Mauritius treaty
  - Singapore
  - UAE
  - USA
- Revised India-Singapore DTAA contains clause that GAAR will override treaty

Beneficial Ownership

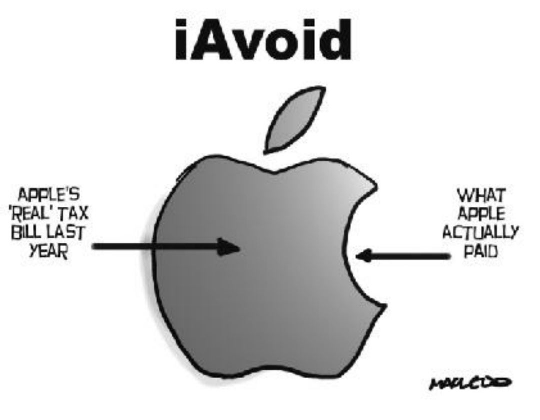
- The Concept of beneficial ownership may be of relevance in the context of conduit companies.
- Its not defined but the term implies restriction on availability of treaty benefits to persons who are not "beneficial owners"
- This concept has been referred in various tax treaty Articles relating to interest, royalty, fees for technical services, fees for included services, dividend of model tax treaty of OECD, US, and UN.
- In general parlance it implies a division between the legal rights and the rights of enjoyment over the economic benefit recognized by law.
- According to Vogel the issue of control is the most important factor to decide who the beneficial owner is. He defines beneficial owner as a person who is free to decide (i) whether or not the capital or other asset should be used or made available for use by others (i.e. the right over capital), or (ii) on how the yields from them should be used (i.e. the right over income), or (iii) both.

Beneficial Ownership



- Co B immediately pays all the interest it receives from Co C. as interest to its parent Co A
- The terms of the loan and interest payment dates are same
- For making payment to Co A, Co B has no other source of funds other than interest earned from Co C.
- Ideally, Co A is the beneficial owner of the interest income from the Co C. Accordingly, Co B not being the beneficial owner of the interest income, cannot avail benefit under India-Netherlands DTAA.

BEPS ACTION PLAN



Base Erosion and Profit Shifting ('BEPS')

CAUSES	CONSEQUENCES
• Conscious Aggressive tax planning and tax dodging by MNEs • Double non-taxation opportunities • Failure of tax rules to keep pace with global corporations and digital economy	• Unfair Competition- MNEs gain competitive advantage compared to domestic enterprises due to BEPS • Burden on other genuine taxpayers • Reduction in revenue of Government

BEPS

- BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profit to locations where there is little or no real activity but the taxes are low, resulting in little or no corporate tax being paid – OECD FAQs
- Base erosion can be caused due to reduction of amount of profits a country can tax by claim of excessive deductions of expenses
- Profit shifting refers to shifting of profits from high tax country to low tax country

Action Plan 1- Addressing The Tax Challenges of Digital Economy

- The mobility accorded in digital business and other features digitisation have posed concerns and challenges before the tax administration, since enterprises engaged in digital businesses, have diverted profits to low-tax jurisdictions where economic activity and value creation is nil or negligible.

- Further, enterprises engaged in digital businesses, have been able artificially avoid taxable presence due to inefficient traditional PE concept which relies on physical presence

- Task Force under Action Plan 1 has come up with the following alternatives:
  - A new nexus in the form of significant economic presence
  - Withholding tax on certain types of digital transactions
  - Equalisation Levy

Action Plan 1 - Addressing The Tax Challenges of Digital Economy

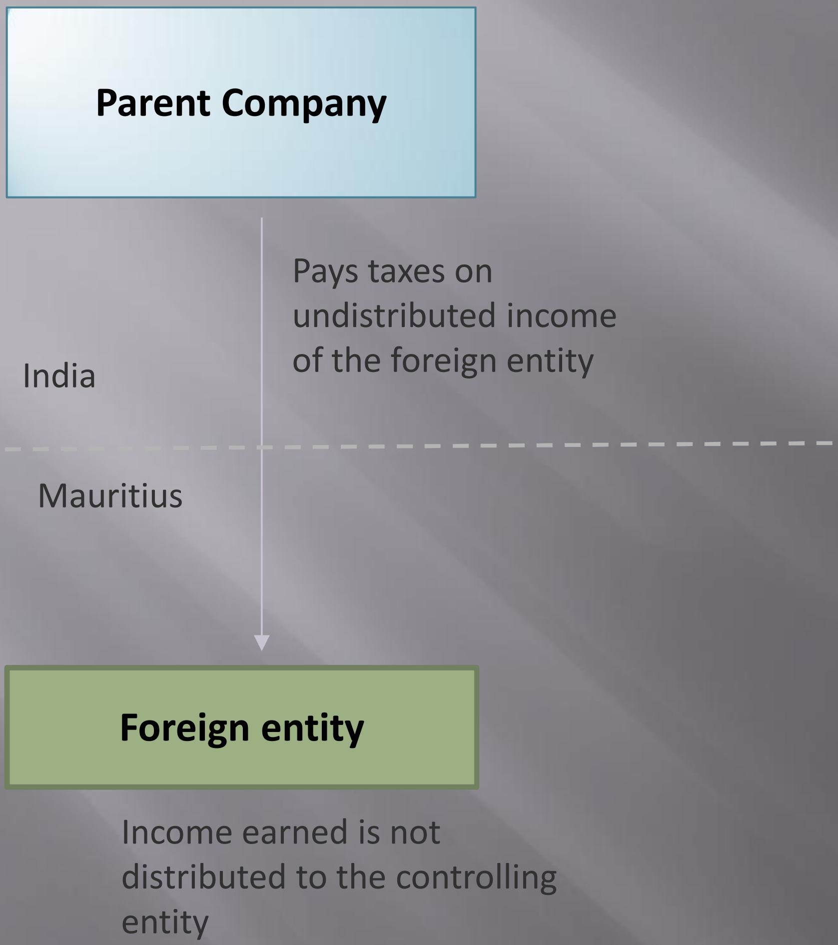
- Change in the definition of PE - Illustration

The maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard.

Action Plan 1 – Indian Perspective

- India has introduced 'equalization levy' through Finance Act 2016 under Chapter VIII.
- Memorandum to Finance Bill 2016
  - The typical direct tax issues relating to e-commerce are the **difficulties of characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction, the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes**
- The Equalisation Levy would be applicable at 6% on gross consideration payable for a 'Specified Service'
  - 'Specified Service' is defined as follows:
    - Online advertisement;
    - Any provision for digital advertising space or facilities/ service for the purpose of online advertisement;
    - any other service which may be notified later.
- The levy will be applicable on the payments received by a non-resident service provider from an Indian resident or an Indian Permanent Establishment ('PE') of a non-resident, in respect of the specified service.
- Credit of equalisation levy would not be available under the DTAA

Action Plan 3 - Controlled Foreign Corporations (CFC)



- CFCs are corporate entities incorporated in an overseas low tax jurisdictions and controlled directly or indirectly by residents of a higher tax jurisdiction
- CFCs mostly earn passive income and such income is not taxed until it is distributed to the parent company and they defer the distribution of income. To curb this CFC legislation are introduced

Action Plan 3 – Controlled Foreign Corporations (CFC)

- IBFD has explained CFC legislation as:
  - “Tax avoidance rules designed to combat the diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation.
  - Income of the controlled company is either deemed to be realized directly by the shareholders or deemed to be distributed by way of dividend
  - Often passive income (dividends, interest & royalties) is dealt in this way
- Approaches for taxing CFC income
  - Jurisdictional approach – If foreign companies are set up in low tax jurisdictions (tax havens), then such foreign company is deemed to be CFC and all income earned by such CFC is taxed in resident country
  - Transactional approach – Only passive income like royalties, interest, etc would be taxed
  - Entity-level approach – Hybrid approach of both jurisdictional approach and transactional approach

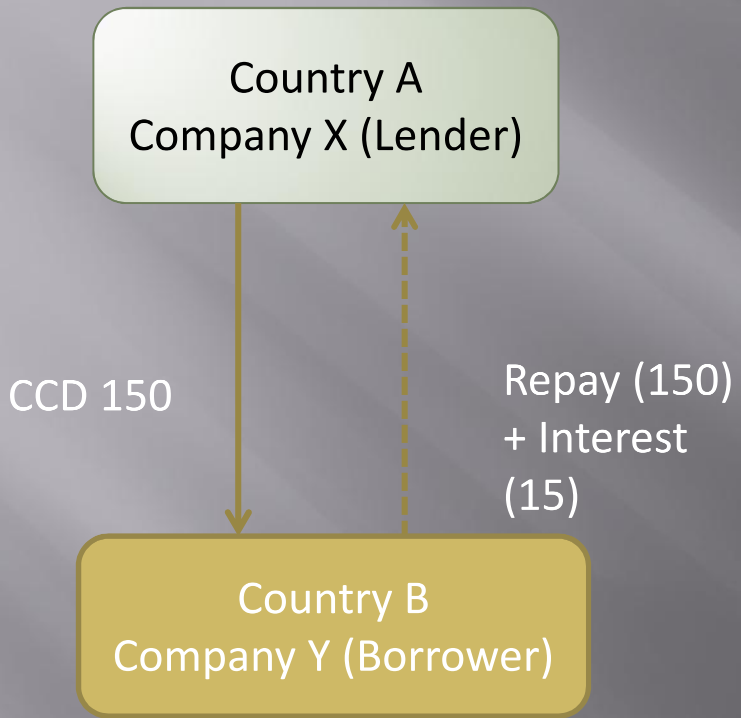
Action Plan 3 – Controlled Foreign Corporations (CFC)

- The report recommends that CFC rules only apply to controlled foreign companies that are subject to effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.
- It recommends jurisdictions with CFC rules allow a credit for foreign taxes actually paid

Action Plan 3 – Controlled Foreign Corporations (CFC) – Indian Perspective

- There is no compulsion for repatriation of profits back to India to the shareholders as per exchange control regulations
- Provisions of section 2(22)(e) were introduced to counter such abuse
- While India currently does not have CFC legislations as a part of its tax legislation, in the proposed Direct Taxes Code (DTC) the concept of CFC regulations has been proposed to be introduced.

Action Plan 4 – Financial Payments



Pre-tax and pre-interest taxable profit - 15
Deduction of interest payment –15
Post- interest taxable profit – 0
Tax rate – 30%
Tax revenue – 0

Facts:

- Company X, a corporation from Country A, establishes a group affiliate Company Y in Country B.
- Company X has with investment of 50 in equity capital and a CCD of 150 at a 10% interest rate in Company Y.
- Company Y generates pre-tax and pre-interest income of 15.

Action Plan 4 – Financial Payments

- Debt financing of cross-border transactions is often favorable than equity financing for taxpayer
  - payment of interest is tax deductible as compared to dividend
  - Distribution tax is payable on dividend
- Thin capitalization refers to excessive use of debt over equity capital which can be through the artificial use of interest-bearing debt instead of equity by shareholders with the sole or primary motive to benefit from tax advantages

Action Plan 4 – Financial Payments

Arm's Length

- The maximum amount of allowable debt is the amount of debt that an independent lender would be willing to lend
- Current TP regulations address interest rate and not amount of debt

Ratio

- The maximum amount of allowable debt on which interest may be deducted for tax purposes based on debt-equity ratio as per FEMA or similar legislation in other countries

Earnings stripping

- This approach focuses on the amount of interest paid or payable in relation to the amount of income out which that interest is paid

Hidden Profits

- Interest would be reclassified as constructive dividend
- This may apply if lender and borrower are related persons

Action Plan 4 – Financial Payments

- GAAR permits re-characterization of debt/equity in an “impermissible avoidance arrangement”
- The Court held in case of DIT v. Besix Kier Dabhol SA (ITA No.776 of 2011) that in absence of thin capitalization rules, there can be no disallowance of interest expense despite a high debt-equity ratio

Action Plan 4 – Financial Payments

- Fixed Ratio – Limits entity’s interest deduction to percentage of its EBITDA (ranging rom 10%-30%)
- A group ratio rule- for groups with high third party debt- Net deduction for interest above fixed ratio to be permitted up to level of net interest/EBITDA ratio of world-wide group

Action Plan 5 - Countering harmful tax practices more effectively, taking into account transparency & substance

- It emphasis on improving transparency and requiring substantial activity for availing any preferential regime
- In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with general principles of taxation in the relevant country.
- It may include preference in form of reduction in tax rate or tax base.

Action Plan 5 - Countering harmful tax practices more effectively, taking into account transparency & substance

- In the context of IP regimes, the substantial activity requirement reflects a “nexus approach,” meaning that countries are allowed to provide preferential tax treatment to IP-related income “so long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income
- Taxpayer allowed to benefit from IP regime only to the extent that the taxpayer itself incurred qualifying R&D expense that give rise to IP income
  - Ensures that taxpayers benefitting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities

Action Plan 5 - Countering harmful tax practices more effectively, taking into account transparency & substance

- The Organization for Economic Cooperation and Development (OECD) has recommended, in Base Erosion and Profit Shifting (BEPS) project under Action Plan 5, the nexus approach which prescribes that income arising from exploitation of Intellectual property (IP) should be attributed and taxed in the jurisdiction where substantial research & development (R&D) activities are undertaken rather than the jurisdiction of legal ownership only.
- In light of this, new section 115BBF to provide that where the total income of the eligible assessee income includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of ten per cent (plus applicable surcharge and cess) on the gross amount of royalty. No expenditure or allowance in respect of such royalty income shall be allowed under the Act.
- An eligible assessee means a person resident in India, who is the true and first inventor of the invention and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1970 and includes evey such person, being the true and the first inventor of the invention

Action Plan 6-Preventing the Granting of treaty benefits in inappropriate circumstances

- Counters treaty shopping
- A clear statement that contracting states intend to avoid creating opportunities for non-taxation/tax avoidance/treaty shopping to be included in treaties
- Limitation of benefit (LOB) rule to be inserted that limit the treaty benefits on fulfilment of certain conditions that establish the link between the entity and state of residence and substance requirements
- A general anti abuse rule based on the principle purposes of the transactions - Principle Purpose Test (PPT) to be inserted to ensure that one of the principle purposes of the transactions is not to obtain treaty benefits

Action Plan 6-Preventing the Granting of treaty benefits in inappropriate circumstances

Illustration:

- RCo, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly.
- It is now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs.
- After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments.
- After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.

Action Plan 6-Preventing the Granting of treaty benefits in inappropriate circumstances

- In this example, whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCo's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits.

Action Plan 7-preventing the artificial avoidance of pe status

- Business profits are taxable in the source state only if there is permanent establishment of an enterprise in the source state

BEPS Concern	Measures Suggested
• Contracts substantially negotiated in contracting state are not concluded in that state as they are finalized or authorized abroad • Independent agent even though it is closely related to foreign enterprise	• Activities by an intermediary leading to regular conclusion of contracts to be performed by foreign enterprise to constitute PE (except in case of activities in course of independent business)
• Core activities of an enterprise considered as preparatory or auxiliary activity	• Exceptions to the definition of PE to be modified
• Fragmenting the operating business into several small operations to argue that each part is engaged in preparatory or auxiliary activity	• Anti fragmentation rule
• Splitting up construction contract between related party	• Principal purpose test

GENERAL ANTI-AVOIDANCE RULES (GAAR)

General Anti-Avoidance Rules (GAAR) - Chapter XIA

- The issue Substance over Form has consistently arisen in the implementation of International and Domestic taxation laws.
- Two possible and conflicting views adopted by Courts
  - That the legal form of transactions could be dispensed with and the real substance of transaction was to be considered while applying the taxation laws,
  - That the form is to be given sanctity.
- To ensure that the correct tax base is subject to tax and counter aggressive tax planning exercises via use of low tax jurisdictions a “substance over form” doctrine in the form of General Anti Avoidance Rule (GAAR) has been codified – With effect from AY 2018-19.

General Anti-Avoidance Rules (GAAR) - Chapter XIA

- Objective of GAAR – a substance over form doctrine
  - To consider the real intention / effect of transactions / purpose of an arrangement while determining the tax consequences, irrespective of the legal structure which camouflages the real intent and purpose
  - To deal with aggressive tax planning

General Anti-Avoidance Rules (GAAR) - Chapter XIA

- Section 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*

- Section 102(10) - *tax benefit" includes,—*

  (a) *a reduction or avoidance or deferral of tax or other amount payable under this Act; or*

  (b) *an increase in a refund of tax or other amount under this Act; or*

  (c) *a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or*

  (d) *an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or*

  (e) *a reduction in total income; or*

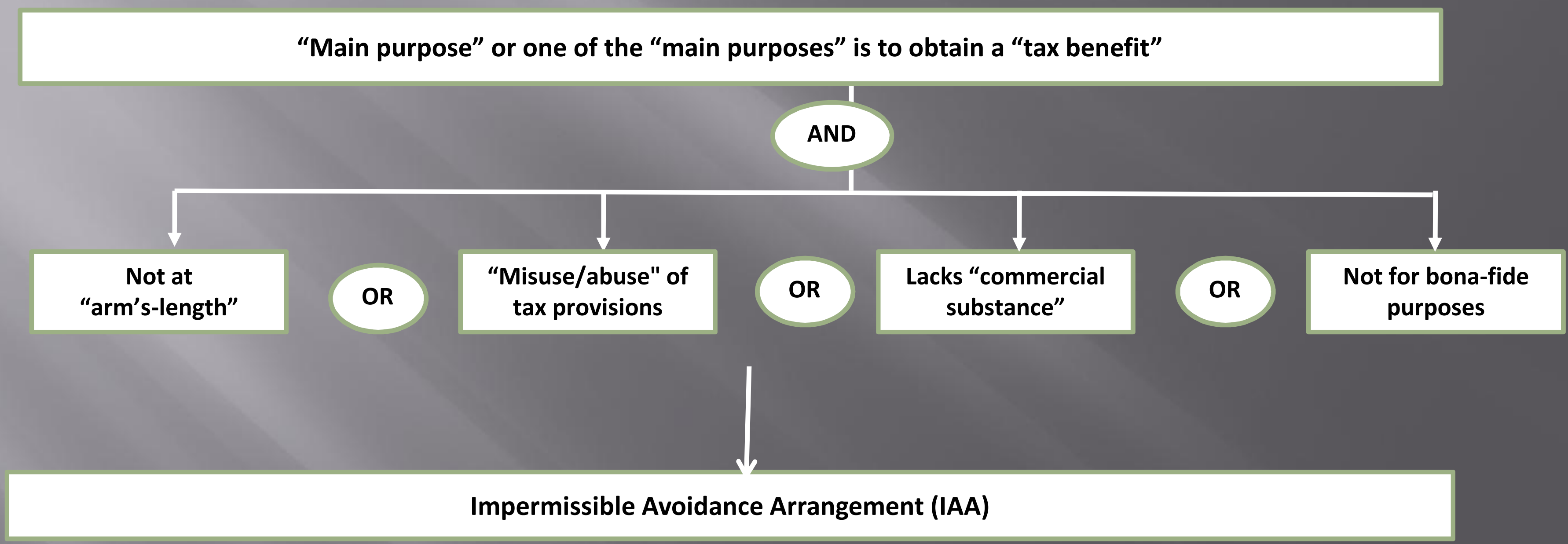
  (f) *an increase in loss,*

  in the relevant previous year or any other previous year;

- The onus to prove that the purpose of the arrangement is not for tax benefit is on the asssessee.

General Anti-Avoidance Rules (GAAR) - Chapter XIA

Section 96 – Impermissible Avoidance Arrangement



General Anti-Avoidance Rules (GAAR) - Chapter XIA

- Main purpose or one of the main purposes of an arrangement is to obtain a tax benefit AND it satisfies at least one of the following four tests under section 96 of the Act:
- It creates rights and obligations not normally created between parties dealing at arm's length
- Results in misuse or abuse of provisions of tax laws
- lacks commercial substance or is deemed to lack commercial substance – Section 97 of the Act Deemed to lack commercial substance examples:
  - substance / effect of the arrangement as a whole - inconsistent with / differs significantly from, the form of its individual steps or a part
  - involves or includes
    - round trip financing – an arrangement in which funds are transferred among parties through a series of transactions without any commercial benefit eg: selling an unused asset to another company, while at the same time agreeing to buy back the same or similar assets at about the same price
    - an accommodating party – a party whose direct or indirect participation in an arrangement is to obtain a tax benefit which would not be obtained without its participation –elements that have effect of offsetting or cancelling each other;
    - Elements that have effect of offsetting or cancelling each other
    - a transaction conducted through one or more persons disguising the value, location, source, ownership or control of fund which is subject matter of such transaction

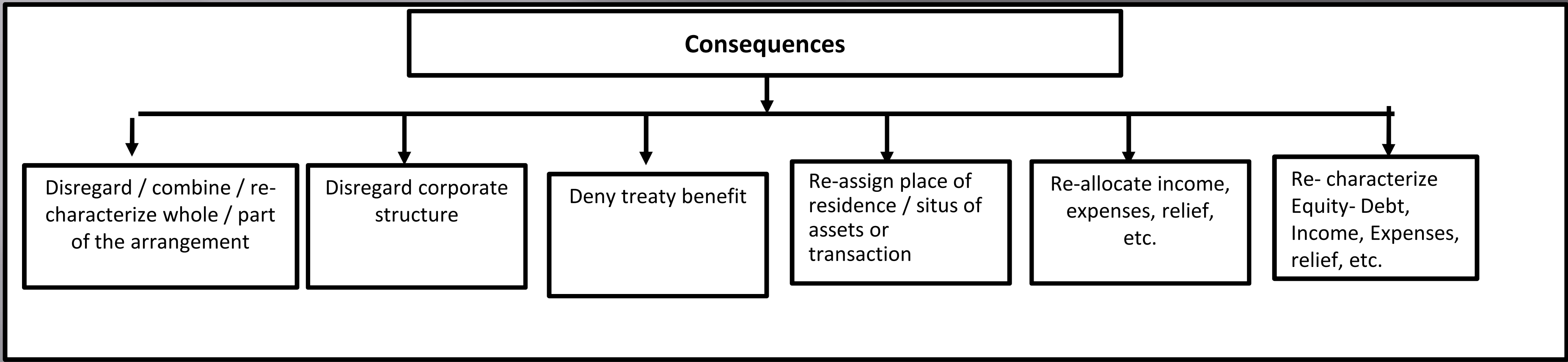
General Anti-Avoidance Rules (GAAR) - Chapter XIA

  - involves the location of an asset / a transaction / the place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining tax benefit for a party
  - Does not have 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 that would be obtained

- Carried out in a manner not normally employed for bona-fide purpose

General Anti-Avoidance Rules (GAAR) - Chapter XIA

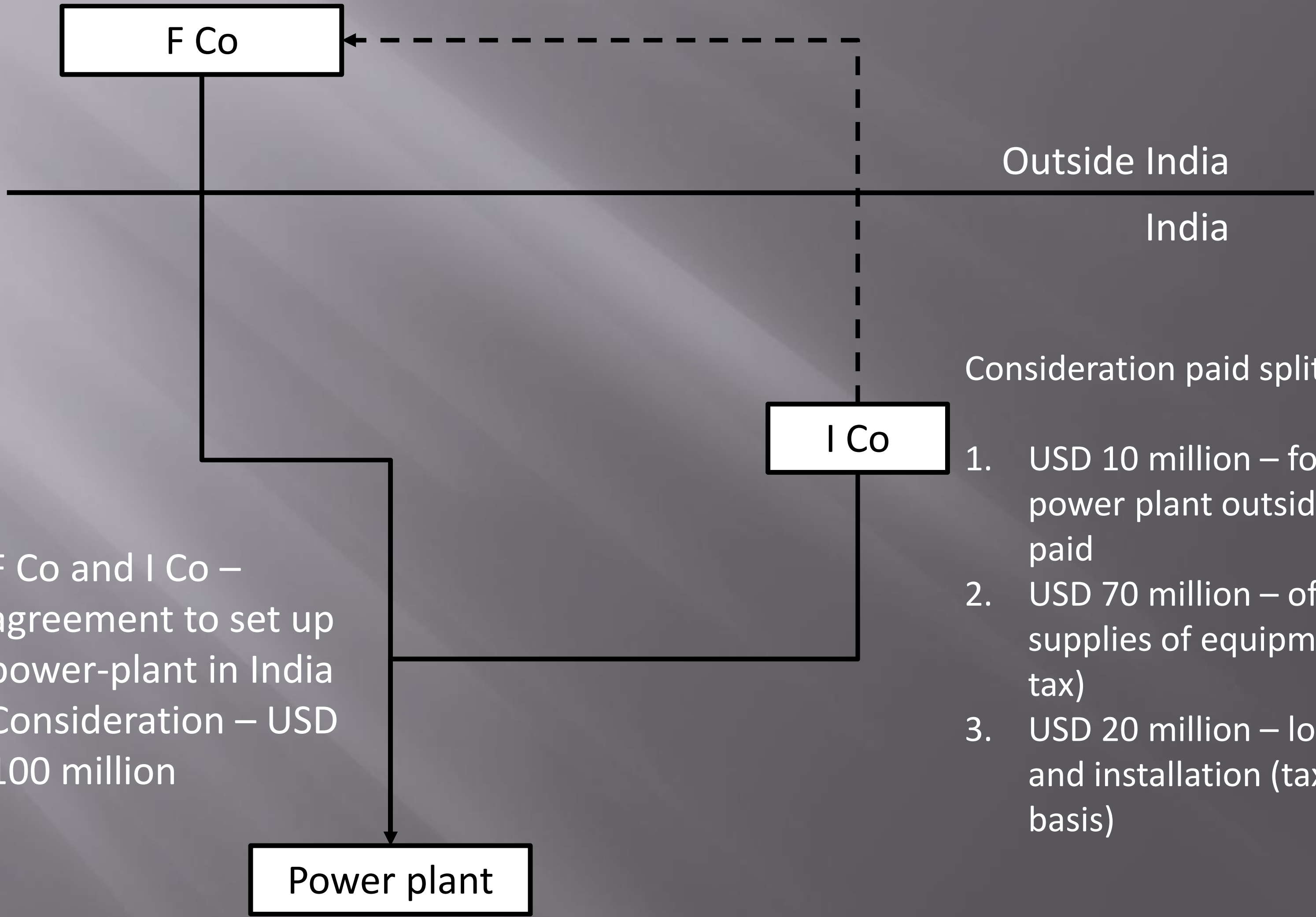
Sections 98 and 99 – Consequences of impermissible avoidance arrangement / Treatment of connected person / accommodating party



Applies to both Indian Residents and Non-Residents

GAAR to override Treaties – The CBDT has issued clarification dated January 27, 2017 wherein it has provided that GAAR can apply to deny treaty benefits even if the treaty contains an LOB clause, where such LOB clause does not sufficiently address tax avoidance

GAAR - It Creates Rights And Obligations Not Normally Created Between Parties Dealing At Arm's Length



F Co and I Co – agreement to set up power-plant in India Consideration – USD 100 million

Consideration paid split up into:

1. USD 10 million – for design of power plant outside India – FTS paid
2. USD 70 million – offshore supplies of equipment (no PE no tax)
3. USD 20 million – local supplies and installation (taxable on net basis)

GAAR - It Creates Rights And Obligations Not Normally Created Between Parties Dealing At Arm's Length

- It is found that the fair market value of offshore design is about USD 30 million; therefore it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case?

GAAR - It Creates Rights And Obligations Not Normally Created Between Parties Dealing At Arm's Length

Answer:

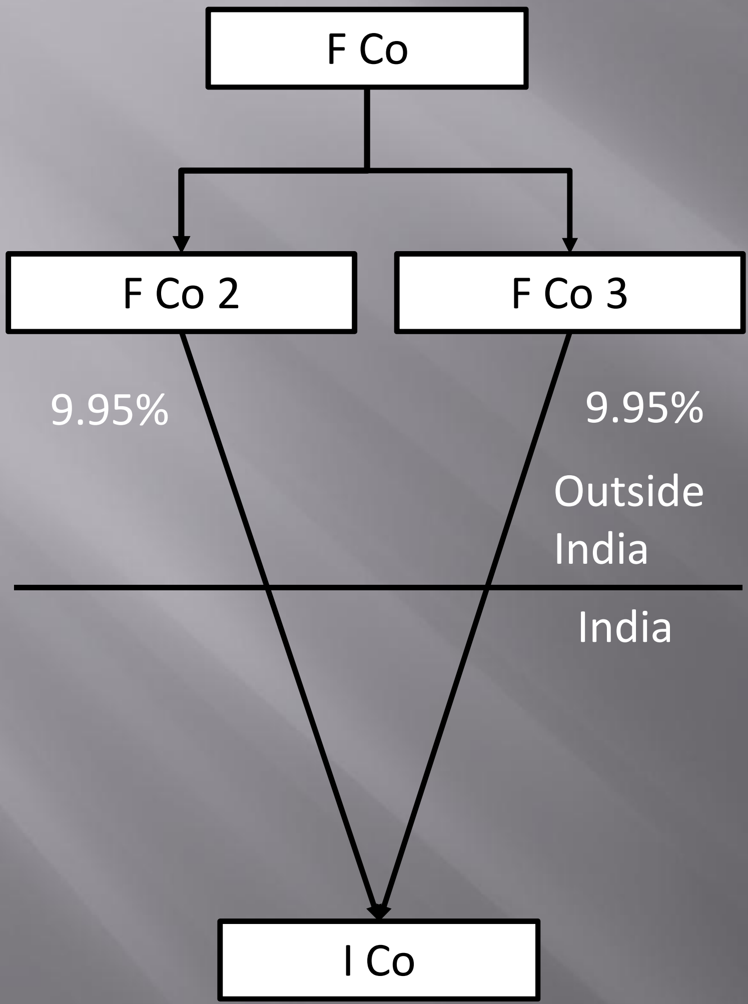
The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied.

(1) The main purpose of this arrangement is to obtain tax benefit; and

(2) the transactions are not at arm‘s length.

Consequently, GAAR may be invoked and prices would be reallocated based on arm‘s length price of each part of the contract determined as per transfer pricing regulations under the Act.

GAAR - Results In Misuse Or Abuse Of Provisions Of Tax Laws



Under the applicable DTAA:

Capital gains arising from the sale of shares of I Co, would be taxable only in F Co Country if the transferor is a resident of F Co Country except where the F Co holds more than 10% interest in the capital stock of I Co – in which case it would be taxable in India.

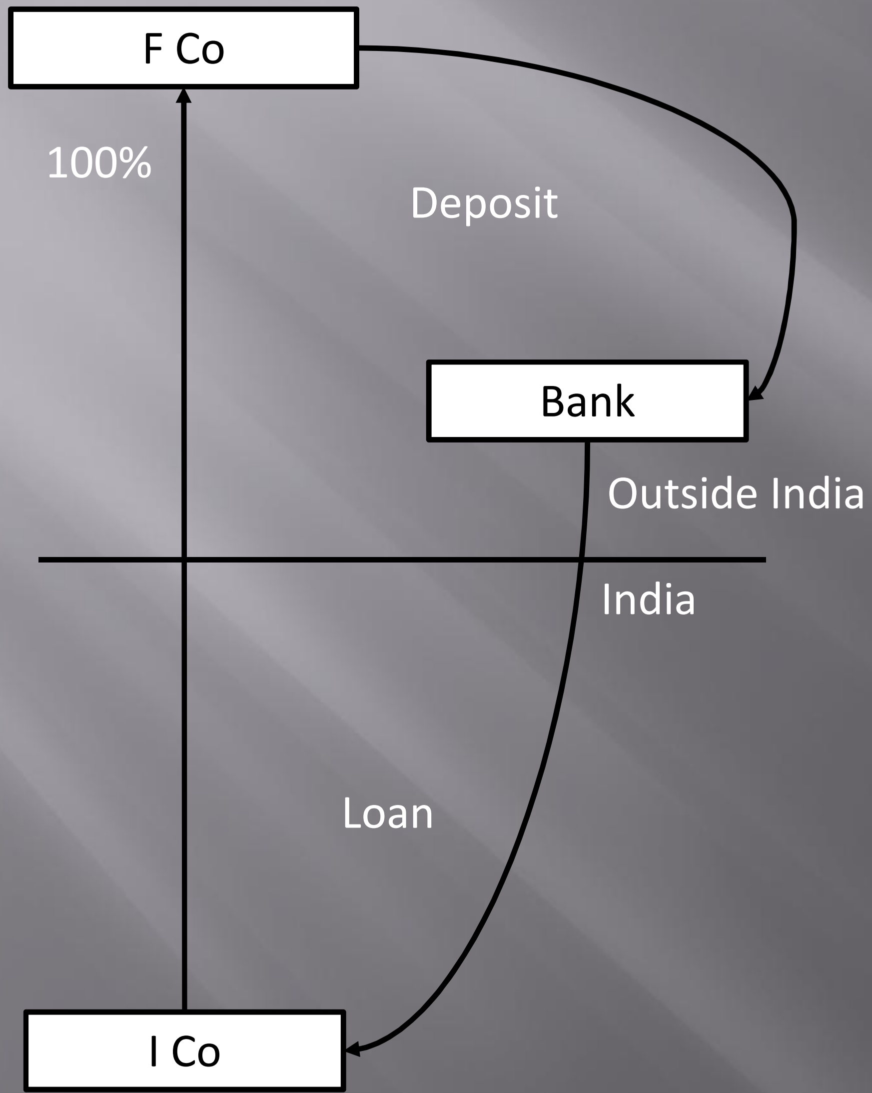
F Co therefore makes investment in I Co through two wholly owned subsidiaries (F Co 2 and F Co 3). Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of I Co. The subsidiaries sell the shares of I Co and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

GAAR - Results In Misuse Or Abuse Of Provisions Of Tax Laws

Answer:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor F Co 1 in any manner (i.e on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement would be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring F Co 2 and F Co 3, the two subsidiaries, or by treating them as one and the same company for tax computation purposes.

GAAR - A Transaction Conducted Through One Or More Persons Disguising The Value, Location, Source, Ownership Or Control Of Fund Which Is Subject Matter Of Such Transaction



F Co has reserves and, if it provides a loan to I Co, it may be treated as deemed dividend under section 2(22)(e) of the Act.

F Co makes a term deposit with the Bank and the bank based on this security provides a back to back loan to I Co.

Assumption: DTAA between both countries provide that interest payment to a banking company is not taxable in India

Can this be examined under GAAR?

GAAR - A Transaction Conducted Through One Or More Persons Disguising The Value, Location, Source, Ownership Or Control Of Fund Which Is Subject Matter Of Such Transaction

Answer:

This is an arrangement whose main purpose is to bring money out of reserves in F Co to India without payment of due taxes. The tax benefit is saving of taxes on income to be received from F Co by way of dividend or deemed dividend. The arrangement disguises the source of funds by routing it through the Bank. The Bank may also be treated as an accommodating party. Hence the arrangement shall be deemed to lack commercial substance.

Consequently, in the case of I Co, the loan amount would be treated as dividend income received from F Co to the extent reserves are available in F Co; and no expense by way of interest would be allowed. In the case of the Bank, exemption from tax on interest under the DTAA may not be allowed as the Bank is not a beneficial owner of the interest, provided the DTAA has anti-avoidance rule of beneficial ownership.

If such anti-avoidance rule is absent in DTAA, then GAAR may be invoked to deny treaty benefit as arrangement will be perceived as an attempt to hide the source of funds of F Co.

GAAR - Carried Out In A Manner Not Normally Employed For Bonafide Purpose

An Indian company A Ltd makes an investment of Rs 1 crore in shares of a listed company on 1st Jan 2020. After a year, the prices go up and fair market value of shares becomes Rs 11 crore. If A Ltd sells these shares, the long term capital gains of Rs 10 crore would be exempt but it would be liable to tax under MAT @ 20%.

A Ltd forms a partnership firm with another person with nominal partnership. It transfers its shares in the firm at a cost price. No capital gain arises as per section 45 of the Act. After a year, the firm sells these shares and realises the gains of Rs 10 crore which is exempt from taxation and no MAT is payable. Subsequently, the firm is dissolved and share of A Ltd in the partnership firm is transferred back along with profits, which is exempt from tax under the Act.

Can GAAR be invoked in this case?

GAAR - Carried Out In A Manner Not Normally Employed For Bonafide Purpose

Answer:

The only purpose of forming a partnership and transferring assets to such firm and selling the shares is to save tax from MAT liability of A Ltd.

Further, there is no commercial substance in the formation of the partnership as it does alter the economic position of A Ltd in terms of business risks or cash flow.
Moreover, the entire exercise is carried out in an abnormal manner. Even holding of shares by the partnership firm for a year or more is no significant economic risk to the company.

Hence, GAAR may be invoked and the partnership firm may be disregarded and capital gains may be taxed under MAT in the hands of A Ltd.

TAX AVOIDANCE VS TAX PLANNING VS TAX EVASION

Tax Avoidance vs Tax Planning vs Tax Evasion

Tax Avoidance

Justice Reddy defines tax avoidance as an “art of dodging tax without breaking the law”

Eg: Shifting of income from a high taxed to a lower-taxed person or jurisdiction

Tax Planning

OECD defines tax planning as “an arrangement of person’s business and or private affairs in order to minimize tax liability”

- Eg: Mr. P deposits Rs. 1 lakh in the PPF Account to reduce his taxable income from 3,40,000 to Rs. 2,40,000

Tax Evasion

Illegal arrangements where liability to tax is hidden or ignored i.e. taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities.

Eg: Colourable devices and illegal arrangements are not permissible (eg:McDowells judgment)

CONCLUSION

Conclusion

- Tax planning i.e. making use of advantages provided by law such as exemptions, deductions, rebates etc without violating any law, was always and will always be permissible.
- Tax evasion i.e. where tax is illegally avoided through illegal means was always and will always be prohibited.
- Tax avoidance / aggressive tax planning involves taking advantages of loopholes in law by merely applying the letter of the law and not spirit would not be permissible by giving preference to substance over form by:
  - Applying GAAR
  - Applying SAAR
  - Adopting BEPS Measures

THANK YOU!