GAAR – issues and case studies

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Where Passion Delivers Value

Pre cursor to GAAR

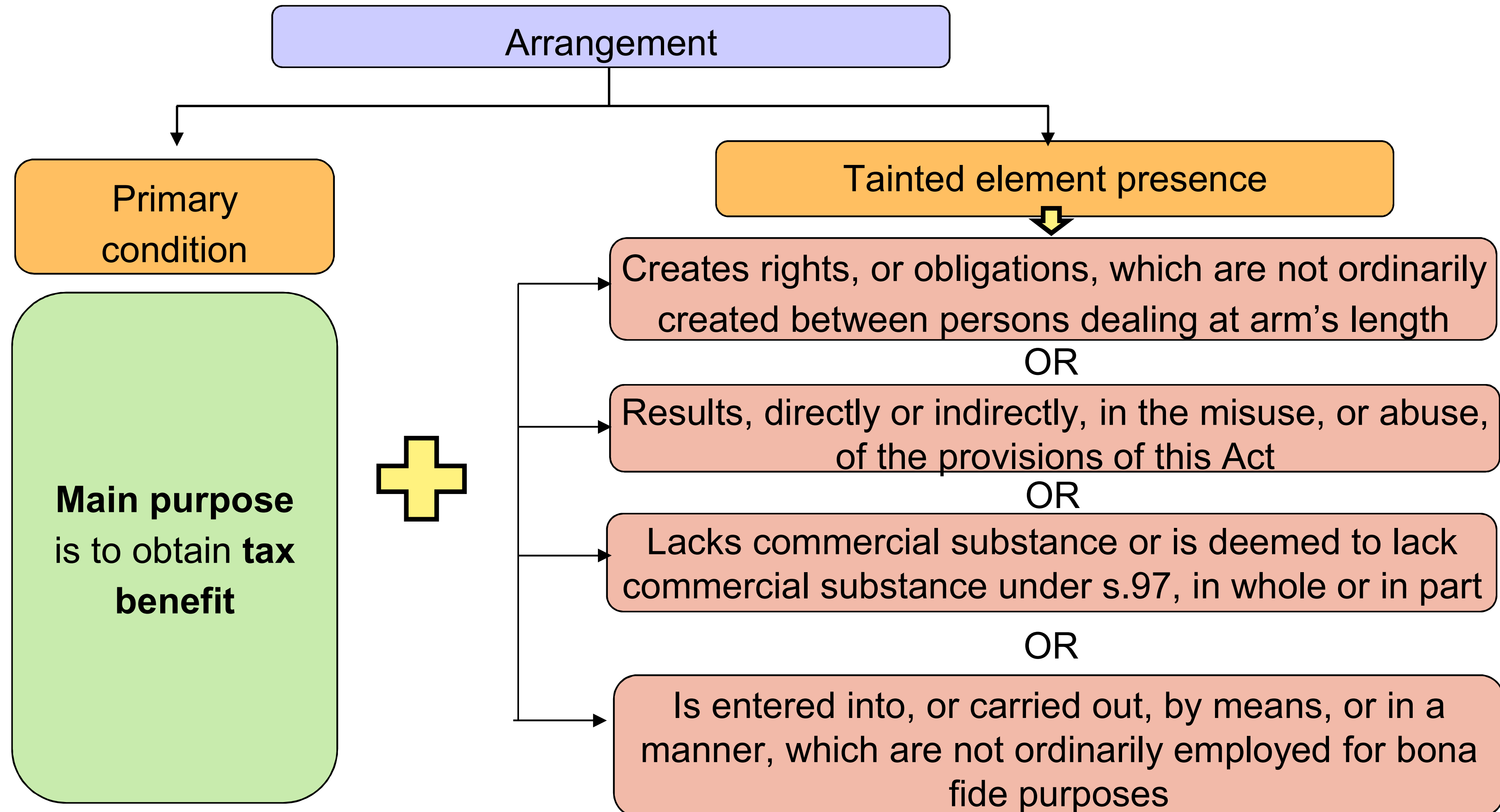
- Every man entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be [Duke of Westminster (1935) AC 1 (UK H.L.)]
- Tax planning may be legitimate provided it is within the framework of law [McDowell & Co. Ltd [154 ITR 148 (SC)]
- The assessee had made use of the said provision of the Act. That such use cannot be called "abuse of law". Even assuming that the transaction was pre-planned there is nothing to impeach the genuineness of the transaction [Walfort Shares & Stock Borkers [(2010) 326 ITR 0001]
- Despite the sound and fury of the respondents over the so called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into : whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper [Azadi Bachao Andolan 263 ITR 706]
- Revenue cannot tax a subject without a statute to support and every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury [Vodafone (341 ITR 1]

Overview of GAAR

- GAAR forms part of Chapter X-A with substantive provisions contained in section 95 to section 102 and section 144BA dealing with procedural provisions
- Delegated legislature
  - Rule 10U – Application of GAAR
  - Rule 10UA – Determination of consequences of IAA
  - Rule 10UB – Notice, forms for reference under section 144BA
  - Rule 10UC – Time limits
  - Circular No 7 of 2017
  - Press Notes
- Key safeguards:
  - Income arising from transfer of investment prior to 1 April 2017 grandfathered
  - De minimis threshold of INR 3 crs for non-applicability of GAAR
  - Two tier vetting by CIT and Approval Panel prior to application of GAAR
- Experiences of Canada, Brazil, Australia for interpretation of provisions

Base conditions

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



Consequences of GAAR

Section	Consequences
98(1)(a)	Disregarding any step or part or whole
98(1)(a)	Combining or re-characterising any step or part or whole
98(1)(b)	Treat as if IAA not entered into
98(1)(c)	Disregard / treat any accommodating party and another as one and same
98(1)(d)	Deeming connected persons to be one and the same
98(1)(e)	Reallocate income/ expense/ relief
98(1)(f)	Treat place of residence, situs of asset or transaction at different place
98(1)(g)	Disregard/ look through any corporate structure

CBDT clarifications (Circular 7/2017)

GAAR v/s SAAR

- SAAR may not address all situations of abuse
- GAAR and SAAR can coexist

GAAR v/s LOB

- LOB may not be sufficient to address all tax avoidance strategies and same may be required to tackle through GAAR
- If avoidance is sufficiently addressed by LOB in tax treaty, there shall not be an occasion to invoke GAAR

Principle of Choice

- GAAR will not interplay with right of the taxpayer to select or choose method of implementing a transaction

Choice of jurisdiction

- If jurisdiction is finalised based on non-tax commercial considerations and main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply

CBDT clarifications (Circular 7/2017)

Grandfathering provisions

- Grandfathering available to investments made before 1 April 2017 in respect of compulsorily convertible from one form to another, split of consolidation, bonus issue
- Lease contracts and loan arrangement are by themselves not 'investments' and hence grandfathering is not available

Impact on NCLT order

- GAAR not applicable if Court has explicitly and adequately considered the tax implications

Corresponding adjustment

- No corresponding adjustment in hands of other party

Deminimus limit of INR 3 crs

- Since GAAR is applicable to arrangement or part of arrangement limit of INR 3 crs cannot be applicable in respect of single taxpayer

Penal provisions

- blanket exemption from levy of Penalty

General interpretation of GAAR

SC of Canada in case of Copthrone Holdings Ltd (2011 SCC 3) laid down some important principles dealing with interpretation of GAAR. Whilst Indian GAAR defers from Canadian GAAR but decision does serve a useful interpretative guideline

General Interpretation

- The GAAR is an unusual mechanism whereby the Courts have the duty of going behind the words of the legislation to determine the object, spirit or purpose of the relevant provisions. Therefore, courts must remember that the GAAR is a provision of last resort.
- The GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.
- The first step in the analysis is to determine the "object, spirit or purpose of the provisions... that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids
- In a traditional statutory interpretation approach, the Court applies the textual, contextual and purposive analysis to determine what the words of the statute mean. In the GAAR context, the analysis is employed to determine the object, spirit or purpose of a provision. The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves

General interpretation of GAAR

General Interpretation

- The second step in the analysis is to consider whether the transaction falls within or frustrates the identified purpose
- There will be a finding of abusive tax avoidance where (1) the transaction achieves an outcome the statutory provision was intended to prevent; (2) the transaction defeats the underlying rationale of the provision; or (3) the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose

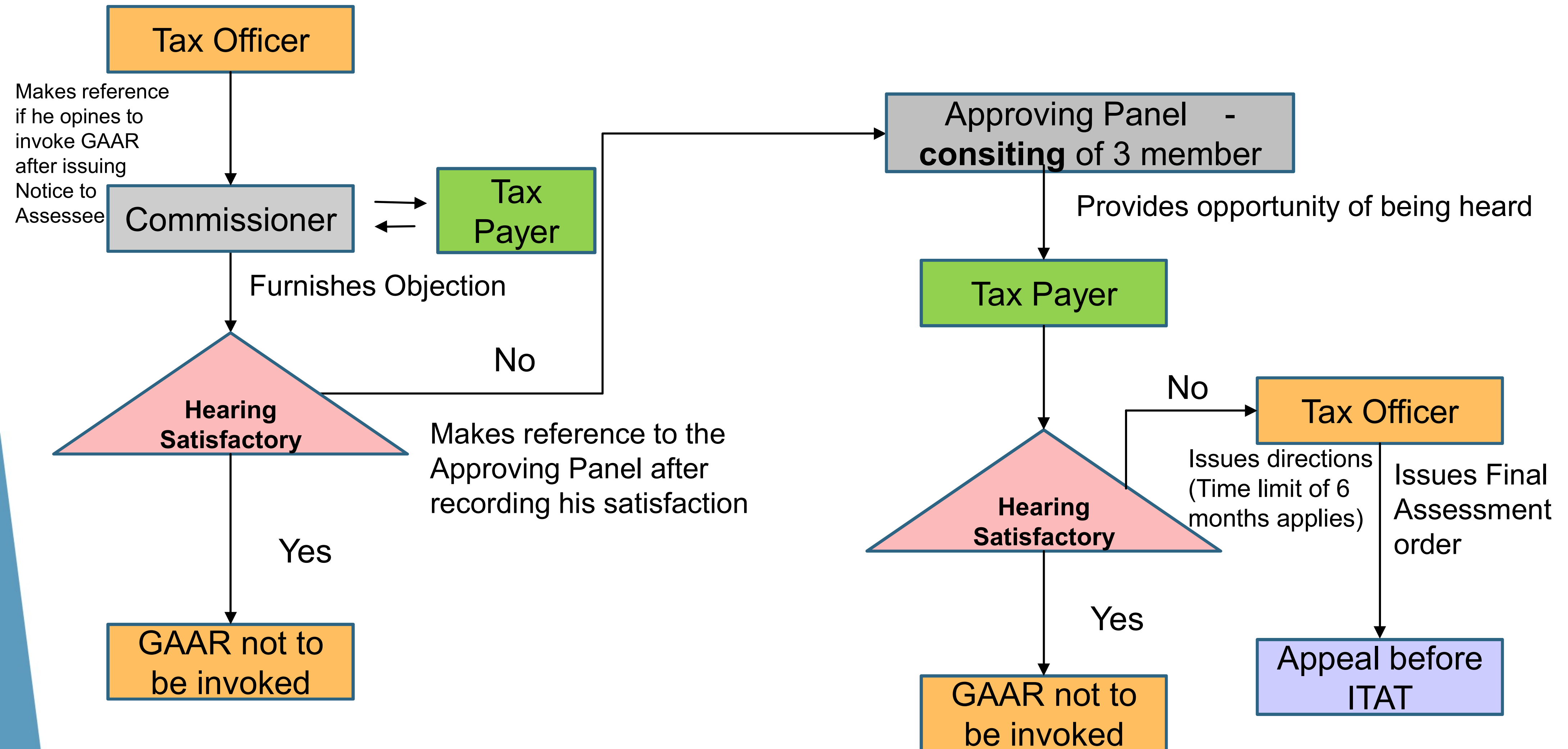
Procedural safeguard

Burden of proof

- FM Speech during discussion on Finance Bill 2012:

  `Remove the onus of proof entirely from the taxpayer to the Revenue Department before any action can be initiated under GAAR"
- Content of section 144BA suggests that onus is on Revenue to prove arrangement is IAA
- However, section 96(2) states that an arrangement shall be presumed unless proved to the contrary by assessee to have been entered into or carried out for main purpose of obtaining tax benefit if main purpose of step in or part of the arrangement is to obtain tax benefit notwithstanding the fact that main purpose of whole arrangement is not to obtain tax benefit
- Thus, on literal reading onus to prove main purpose of arrangement is not to obtain tax benefit is on assessee but onus to prove satisfaction of tainted element test is on revenue
- 3 tier forum should adhere to principle of fairness and natural justice while adjudicating matter before it
- Interestingly, scope of AP is restrictive to determine arrangement to be IAA. Consequences can be determined by AO with approval of CIT or PCIT

3 tier procedural safeguard



Procedural safeguards

Authority	Procedure	Remarks

AO	• Issue notice containing:
	  • Details of arrangement
	  • Tax benefit arising under arrangement
	  • Basis and reason for considering that main purpose of identified arrangement is to obtain tax benefit
	  • Basis and reason why arrangement satisfies tainted element test
	  • List of documents and evidence relied upon
	• Reference to CIT in Form No 3CEG
		• Rule 10UB does not require AO to state the consequences of IAA to assessee
		• Form No 3CEG requires AO to state consequences of IAA
		• Writ possible:
		  • Principle of natural justice not followed
		  • No relationship of basis to form belief on IAA and satisfaction of tainted element test basis documents and evidence on record

Procedural safeguards

Authority	Procedure	Remarks

CIT/PCIT	• If CIT/PCIT is satisfied GAAR need not be invoked he shall issue direction to AO
	• If not satisfied, CIT/PCIT to issue notice setting out reasons and basis of such opinion for submitting objections
		• Possible for assessee to ask Form 3CEG with supporting documents
		• Direction for not invoking GAAR binding on AO and cannot be appealed
		• In absence of assessee objection or representation no recourse to AP and order of CIT/PCIT is final
		• Not permissible for CIT/PCIT to improvise AO reasoning for application of GAAR or adding arrangement or limbs of tainted element test not identified by AO
		• No power of enhancement or consideration of matter not considered by AO
		• Writ possible:
		    • Mechanical satisfaction
		    • Principle of natural justice not followed
		• No explicit power to remand matter or admit additional evidence

Procedural safeguards

Authority	Procedure	Remarks

AP	• AP panel shall issue such direction in respect of IAA as it deem fit
	• Opportunity of being heard to be provided to AO and assessee
	• Power to make further inquiry, call for additional record or evidence
	• Give direction within 6 months from the end of the month in which reference was received
		• AP may specify year or year to which IAA applies.
		• Direction to be given by way of speaking order
		• Writ possible:
		  • Mechanical satisfaction
		  • Principle of natural justice not followed
		  • Order passed beyond 6 months
		• Not permissible for AP to improvise CIT/PCIT reasoning for application of GAAR or adding arrangement or limbs of tainted element test not identified by AO
		• No power of enhancement or consideration of matter not considered by AO

Other aspects

- Adjudication by Tribunal on non-GAAR issue without been considered by CIT(A) or DRP [See 144C(14A) & section 246A]
- If AP specified more than one year to which IAA applies how effect will be giving in other years in following situations
  - Assessment completed and no addition made
  - Assessment completed and non-GAAR issue before CIT(A)/Tribunal
  - Return of income filed but no notice u/s 142(2) issued
  - Order if rectified under section 154 – can it be said it is mistake apparent from record; if order is reopened – whether jurisdictional conditions of section 147 needs to be complied with ?
- Penal provisions to be pursued under normal route without procedural safeguards

CS 1: Super Rich Tax

Increase in Surcharge

- Increase in Surcharge for individual earning income above 2 crs

Individual	0 – 50 L	0.50 – 1crs	1 – 2	2 – 5	5 and above
MMR	30%	30%	30%	30%	30%
Surcharge	Nil	10%	15%	25%	37%
Tax Rate (inclusive Surcharge)	30%	33%	34.5%	37.5%	41.1%
Cess	4%	4%	4%	4%	4%
Tax Rate	31.2%	34.32%	35.88%	39%	42.744%
Pre-amended rate	31.2%	34.32%	35.88%	35.88%	35.88% (Note 1)
Dividend Income above 10 L	10%	10%	10%	10%	10%

Note 1: Earlier surcharge of 15% for income exceeding Rs. 1 crores now replaced with 25% and 37% for income between Rs. 2 crs to 5 Crs and above respectively.

Scope of levy

Scope

- Increased surcharge is applicable to individual, HUF, AOP, BOI and artificial juridical person

AOP

- Increased rate likely to be detrimental to AOP formed for executing project under consortium arrangement

Artificial Juridical Person

- AJP will be assessed to higher tax which may include
  - Bar Council
  - Idol
  - Diety

Scope of levy

Specific Trust

- In case of Specific Trust, income is assessed in hands of representative assessee in same manner and like extent as that of beneficiary. Accordingly, status of beneficiary would be relevant

Discretionary Trust

- Discretionary Trust are not separate person under Act. Courts in following cases has held discretionary Trust to be individual
  - CIT v SAE Head Office Monthly Paid Employees Welfare Trust [2004] 141 Taxman 364 (Delhi)
  - CIT v. Food Corpn. of India, Contributory Provident Fund Trust [2009] 177 Taxman 224 (Delhi)
- Sec 164 provides that tax shall be charged at maximum marginal rate (MMR)

Scope of levy

Section 2(29C)

MMR means the rate of income-tax (including surcharge on income tax, if any) applicable in relation to the highest slab of income in case of an individual, association of persons or, as the case may be, body of individuals as specified in the Finance Act of the relevant year

- Issue : Rate applicable to DT if income is less than 5 crs
- Possible view: 42.74% rate should not apply and surcharge as applicable on total income should apply
  - Use of words 'surcharge, if any' and 'highest slab of income'
  - Surcharge is applicable on 'total income' which has nothing to do with rates
  - Decisions in support:
    - CIT v C.V. Divakaran Family Trust [2002] 122 Taxman 405 (Kerala)
    - ITO v Tayal Sales Corporation [2003] 1 SOT 579 (HYD.)

Tayal Sales Corporation.....extract

“Section 2(29C) does not say that maximum marginal rate shall include surcharge on Income-tax invariably rather the words used in section 2(29C) are that surcharge is to be included, if any, applicable in relation to the highest slab of income. Section 4 of the Income-tax, Act 1961 provides that income shall be charged in accordance with and subject to the provisions of this Act. The levy of surcharge is governed by the Finance Act which provided for the relevant year that surcharge was applicable, if the total income of the firm exceeded Rs. 1 lakh. In the instant case, the total income of the assessee-firm was less than Rs. 1 lakh.”

Tax Arbitrage

- Tax Arbitrage – Essential to select appropriate entity for doing business

Type of Person	Individual	LLP	Company*
Income (i)	15 crs	15 crs	15 crs
Tax Rate (including Surcharge and cess) (ii)	42.744%	34.94%	29.12%
Tax (iii) = (i)*(ii)	6.41 crs	5.24 crs	4.37 crs
Profit available for Distribution (iv) = (i)-(ii)	N.A.	9.76 crs	10.63 crs
Rate of Dividend Distribution Tax (v)	N.A.	Exempt	20.56%
Distribution Tax (vi) = (iv)*(v)	N.A.	Nil	2.19 crs
Balance income (vii) = (iv) – (vi)	N.A.	9.76 crs	8.45 crs
Rate of Tax on dividend exceeding 10 lakhs (viii)	N.A.	N.A.	10%
Tax on dividend exceeding 10 lakhs (ix) = (vii)*(viii)	N.A.	N.A.	0.84
Net Income in the hands of Individual (x)	8.59 crs	9.76 crs	7.6 crs
Effective tax rate (xi) = (x)/(i)	**42.744%**	**34.94%**	**50.68%**

*Note 1: Based on the assumption that turnover of company will be below Rs. 400 crs

CS 2: Buy back tax

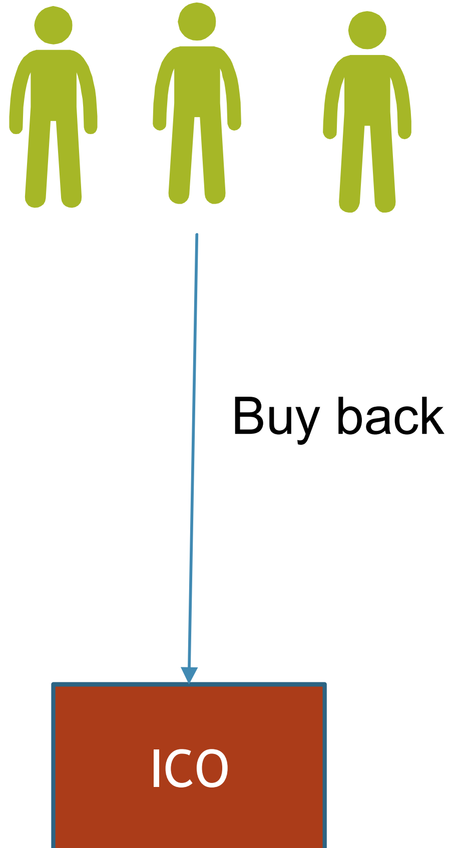
Memorandum to FB 2019

Strengthening anti-buse measure

Tax on income distributed to shareholder in case of listed companies

"This section was introduced as an anti-abuse provision to check the practice of unlisted companies resorting to buy-back of shares instead of payment of dividends. This practice of widespread abuse was noted, in the past, amongst unlisted companies where the taxpayers preferred it for tax avoidance, as tax rate for capitals gains was lower than the rate of Dividend Distribution Tax (DDT). However, instances of similar tax arbitrage have now come to notice in case of listed shares as well, whereby the listed companies are also indulging in such practice of resorting to buy-back of shares, instead of payment of dividends."

Facts (Pre 5 July 2019 buy back)



Facts:

- ICO has earned substantial profit over past years and declared dividend at less than industry standard
- ICO proposes to distribute surplus cash amongst shareholder
- ICO proposes to undertake buy-back under section 68 of Cos Act 2013 read with relevant rules every year

Regulatory provisions

- Buy back tax is taxed in hands of company at 20% and exempt in hands of shareholder
- Dividend is taxable in hands of company effectively at 20.36% and in hands of shareholder at 10% (assume dividend income exceeds Rs 10L)
- AO proposes to treat buy-back as dividend

Person to whom GAAR applies

Parties to the transaction

- Section 95(1) provides that 'an arrangement entered into by an assessee may be declared to be an IAA'. Section 96(2) deems arrangement 'entered into' or 'carried out' by assessee to be IAA
- Accordingly, law requires AO to determine assessee which has 'entered into' arrangement
- Facts of the case:
  - Possibility 1: All shareholder and ICO are considered as assessee who has 'entered into' arrangement and accordingly GAAR is invoked in all cases
  - Possibility 2: Only ICO is considered as assessee who has 'entered into' arrangement and GAAR is invoked only in case of ICO
- This is essential as procedural safeguards will need to be followed for all taxpayers

Tax Benefit

Tax Benefit

- GAAR shall not apply to an arrangement where the tax benefit in the relevant assessment year arising in aggregate to all the parties to the arrangement does not exceed 3 crs [Rule 11U(a)]
- Read strictly, provisions are applicable:
  - Even if GAAR is not invoked in assessment of each of the parties but overall benefit exceeds 3 crs
- Arguably, tax benefit even though defined expansively does not include interest, penalty
- If in any assessment year, tax benefit is less than 3 crs, said year gets excluded from GAAR
- No guidelines for computing tax benefit. Arguably, tax benefit needs to be computed considering alternative which gives same commercial result

Counterfactual

Taxpayer

- Circular No 7 recognises choice principle
- Buyback has definite consequences
  - Change in debt equity ratio
  - Embargo to raise capital of similar nature for 1 year
  - Reduction in number of shares and impact on EPS
  - Reduction in company liability to pay shareholder at the time of liquidation
- Legislature provides deduction of cost of share for computing BBT

Revenue

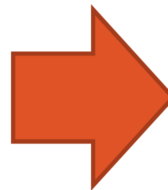
- Company benefits by paying lower DDT and shareholder by not paying extra tax on dividend
- Commercially both option have same consequences except for loss to exchequer
- Buy back as option amount to mis-use or abuse of provisions
- No rationale company would undertake buy-back every year

SEBI Guidelines

- SEBI (Buy-back of Securities Regulations) 2018 permits following modes of buy back

Buy back through tender offer

- Company fixes a buyback price and accepts shares on a proportionate basis during the buyback period
- Shareholders will be sent a letter of offer; a form is to be filled in with the necessary details and sent back to the company accompanied by the required documents



Buy back from open market

- Company specifies a maximum price and buys back shares from the market during a defined time period
- Although the company may declare a maximum buyback price, it does not mean that the investors who sell during the buyback period will realise that maximum price
- Company can buy in tranches at different prices

Taxability pre-amendment

Tax on Buyback

- Taxability depends whether shares are held as capital asset or stock in trade
- Taxable as business income if shares are held as stock in trade:
  - Possible to set off brought forward losses
  - Possible to set off gains on Script A (buy back) with loss from Script B (secondary market sale)
  - Taxed at rate applicable to company (higher than BBT rate)
- Investment by FPI deemed to be held as capital asset
- Shares held as capital asset subject to capital asset and computed in accordance with section 46A read with section 48

Taxability pre-amendment

Tax on Buyback

- Rate of tax depends upon period of holding
- STCG taxed at 15% under section 111A
- LTCG on Buy back of shares on which STT is paid:
  - No tax if LTCG is less than Rs 1 lakh;
  - LTCG in excess of 1 lakh taxable at 10% without benefit of indexation or foreign exchange fluctuation;
  - Gain accrued on equity shares till 31 January 2018 exempt by providing cost step up in cost of acquisition formula;
  - Notification No 60/2018 grants aforesaid benefit to shares acquired in certain modes even if no STT is paid;

Taxability pre-amendment

Tax on Buyback

- LTCG on non-STT paid shares taxable under section 112 at 10% or 20% (after taking indexation benefit for resident shareholder)
- Individual and HUF can avail benefit of slab rate and no income is chargeable if LTCG or STCG does not exceed maximum amount which is not chargeable to tax
- LTCG or STCG included for MAT computation and accordingly MAT payable on such income
- Non-resident can avail treaty benefit and accordingly gains may not be chargeable to tax depending upon treaty and period of investment

Buy back tax

Overview of existing section 115QA

- Additional income tax payable at 20% on distributed income ('DI') [S. 115QA(1)]
- DI means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares determined in the manner as prescribed under Rule 40BB
- BBT is payable even if no income tax is payable by domestic company [S. 115QA(3)]
- Principle officer of Company required to pay BBT within 14 days from date of payment of consideration to shareholder.

Implication of changed regime

- BBT payable at 20% irrespective of period of holding, whether shares were held by shareholder as capital asset or stock in trade, whether shareholder paid STT at the time of acquisition of shares, mode of acquisition of share
- Neither Company nor shareholder can set off its brought forward losses resulting in higher economic taxation
- Buy back taxable in hands of company irrespective of quantum of consideration to shareholder. Thus, benefit of slab rate or Rs 1 lakh floor exemption not applicable
- Shareholder cannot avail benefit of section 54F
- Benefit of cost step up considering 31 January 2018 value not available as DI formula or existing Rule 40BB does not provide such benefit

Implication of changed regime

- Treaty benefit to tax resident of following countries will not be available as BBT is tax on company and not shareholder

Country	Relief
Mauritius, Singapore, Cyprus	• Gains from alienation of shares acquired prior to 1 April 2017 not taxable in India
Netherland	• Alienation of share of Indian company from non-resident to resident shareholder is taxable in India. However, gains realized on alienation is not taxable if it is realized in course of a corporate organization, reorganization, amalgamation, division or similar transaction • Mumbai Tribunal in Accordis Baheer BV (66 taxmann.com 164) ruled that buy back is not covered by above exception

Implication of changed regime

- Treaty benefit to tax resident of following countries will not be available as BBT is tax on company and not shareholder

Country	Relief
France	• Gains from alienation of shares representing a participation of at least 10% in resident company is taxable in France

- Following are other practical challenges which taxpayer are likely to face:
  - BBT requires company to reduce amount received by it for issue of such share as determined under Rule 40BB. This is onerous task.
  - In tender offer it may still be possible by asking shareholders to provide proof of cost in terms of Rule 40BB. Considering various situations are covered by Rule 40BB, issue arises whether Company can compute BBT basis of declaration from shareholders?

Implication of changed regime

- Following are other practical challenges which Company undertaking buyback is likely to face:
  - Rule 40BB does not case of secondary acquisition and hence it will be difficult for company to compute BBT
  - Considering that BBT is additional tax on company and income is exempt in hands of shareholder, it is possible that shareholders may not provide cost details
  - In case of open market, it may be difficult to know 'amount received by company for issue of such share' as Buy back is undertaken like any other transaction of sale and purchase on stock exchange. It may not be correct to say that difficulty in obtaining cost information makes cost unascertainable and accordingly computation mechanism fails
  - From shareholder perspective, it may be difficult to know that shares sold under open offer where one bought by company and accordingly income is exempt . Regulation17 of SEBI guidelines provides that identify of Company as a purchaser shall appear on electronic screen when order is placed

Implication of changed regime

- Following are other practical challenges which taxpayer are likely to face:
  - Section 115QA(3) requires principal officer to pay BBT within 14 days of payment of consideration. SEBI guidelines provides that buy back under open market shall open not later than 7 working days from the date of public announcement and shall close within 6 months from date of opening of the offer. Accordingly, listed company will need to monitor buy back and pay BBT at multiple intervals to comply with law
  - Income of shareholder is exempt under section 10(34A). Appears drafting lacuna that words 'not being company in which public are substantially interest' is not deleted
  - Consideration received by shareholder not subject to MAT as Explanation to section 115JB provides for reduction of section 10 income

Implication of changed regime

- Provisions are applicable to any buy back of shares undertaken on or after 5 July 2019. Thus, amendment is in a way retroactive
  - Section 294 reads ‘if on the 1st day of April in any assessment year provision has not yet been made by a Central Act for the charging of income-tax for that assessment year, this Act shall nevertheless have effect until such provision is so made as if the provision in force in the preceding assessment year or the provision proposed in the Bill then before Parliament, whichever is more favourable to the assessee, were in force
  - Finance Act 2019 introduced on 1 February 2019 provided for continuity of existing rate for FY 2019-20, it is doubtful whether benefit of section 294 can be availed by company given that there is an Act for charging of income-tax for FY 2019-20

CS 3 : Revaluation and retirement

Facts

- Megastar is a partnership firm into garment manufacturing and has adjoining land parcel of un-operational mills under its control
- A, B , C & D are fourth generation partners and desire to monetise its asset. E & F are real estate developers
- Commercially it is agreed to revalue land and credit partner capital account. E & F will bring in requisite capital as also raise debt by mortgaging land.
- A, B & C will retire immediately and withdraw cash. D will withdraw after completion of project. E&F has agreed to pay interest @ 18% on partner capital and D will be sleeping partner.
- Megastar follows project completion method and it is agreed that D capital will be paid before completion of project

Facts

Detail	A	B	C	D	E	F	Total
Capital	100	100	100	100			400
Revaluation	5000	5000	5000	5000			20000
Admission					200	200	900
Less: Retirement	5100	5100	5100				

Position of law

- Revaluation of assets and crediting surplus in partners account is not taxable
- Withdrawal of capital in cash is not taxable in hands of partner or firm
- Refer following illustrative decision:
  - Mahul Contruction Corporation v ITO [2017] 88 taxmann.com 181 (Mumbai - Trib.)
  - CIT v Dynamic Enterprise [2013] 40 taxmann.com 318 (Karnataka) (FB)
  - Electroplast Engineers [TS-168-HC-2019(BOM)]

Counterfactual

Taxpayer	Revenue
• It is accepted mode of retirement from business. Courts have widely accepted said thing in past and there is nothing abusive • Not all partners have retired • Retirement was simplest form of monetisation as other option like sale of land, sale of partnership interest are time consuming and involves stamp duty	• In substance, partners have sold entire business • It represents misuse or abuse of law • Entire amount is taxable in hands of partner • Retention of D is in substance financing arrangement as he is sleeping partner as also exit is provided prior to credit of profit of real estate

Assume arrangement is an IAA – ensuing slides highlights consequences which AO is required to determine

Consequences of GAAR

Section	Consequences
98(1)(a)	Disregarding any step or part or whole
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98(1)(f)	Treat place of residence, situs of asset or transaction at different place
98(1)(g)	Disregard/ look through any corporate structure

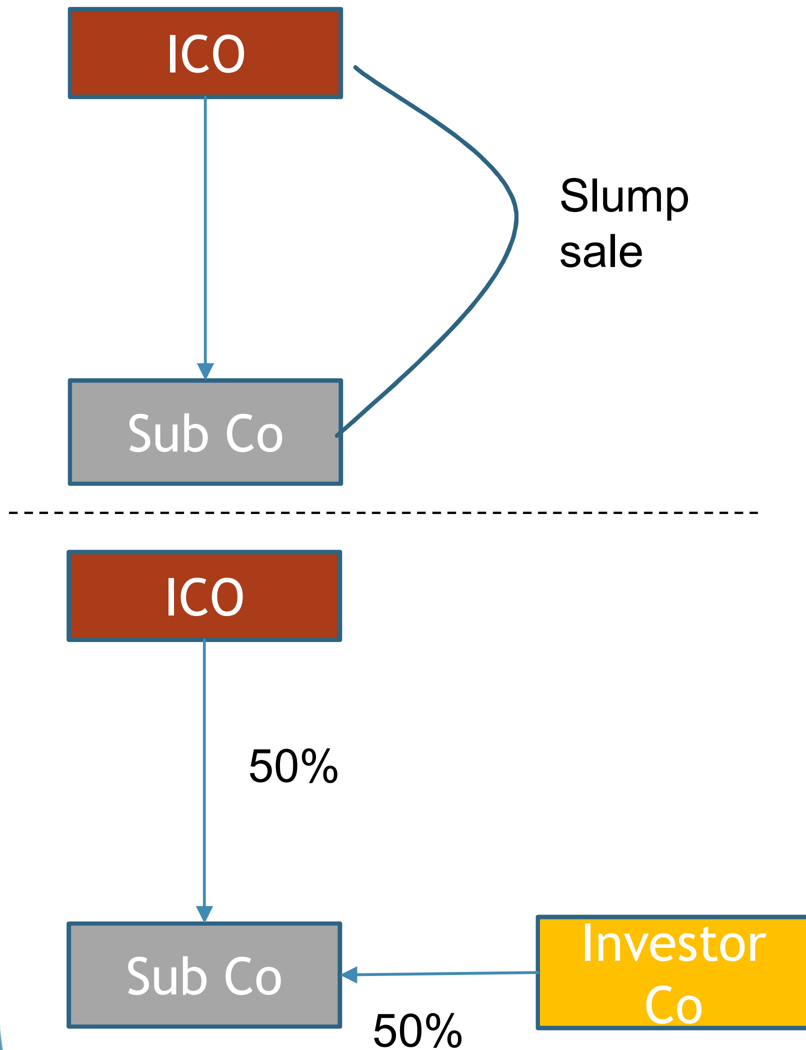
Aforesaid consequences are illustrative – law gives wide power to AO to determine consequence in such manner as it deem fit

Consequences of GAAR

- Possible conclusion by AO
  - Alternate 1: Sale of partnership interest
  - Alternative 2: Transfer of underlying land
- Consequences determined by AO has to be approved by CIT/PCIT/AP. Thereafter order is appealable in Tribunal
- Arguably, CIT/PCIT should apply mind and record satisfaction objectively and not mechanically
- Arguably, no power of enhancement to CIT/PCIT/AP
- If AO determines alternative 1 – what is cost of interest in partnership firm?
- In case of alternative 2, if it amounts to transfer of land, then capital gains tax should be taxed in hands of firm and not partners

CS 4 : Externalisation

CS 4A : Externalisation



Facts:

- ICO has multiple business. ICO has developed IP in artificial intelligence which will be gamechanger in technology
- To exploit IP, ICO proposes to have a JV with financial partner
- ICO transfers business to Sub Co (99% owned) slightly higher to book value on slump sale basis [Rs 1 crs]
- Investor Co values AI at Rs 100 crs and acquires 50% sake by infusing Rs 50 crs which will be utilised to set up manufacturing facility

GAAR action:

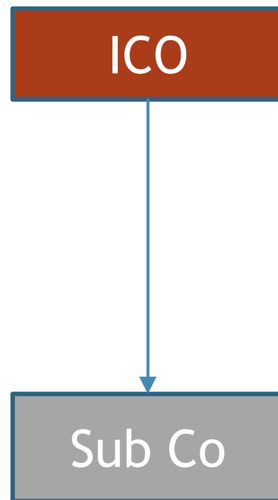
- AO invokes GAAR and contends ICO should have transferred business at Rs 100 crs

CS 4A : Externalisation

Issues

- What is main purpose of transaction – raising of capital or to obtain tax benefit
- Can AO substitute fair value of consideration in absence of back up legislative provisions e.g. 50C, 50CA etc
- Can AO deem accrual of income to ICO though in reality none is received. In otherwords whether notional adjustment in GAAR override section 4 read with section 5 of Act
- Assuming AO succeeds in substituting consideration – what will be cost of Sub Co shares at the time of disposal
- Since Sub Co does not have surplus cash, can assessee contend to AO to treat transaction as slump exchange i.e. value of consideration is built in shares of Sub Co

CS 4B: Externalisation



Liability	Rs	Asset	Rs
Equity	100		
10% loan from ICO	9900	Asset	10000

Facts:

- ICO incorporated Sub Co for its technology business
- Capital was infused in form of minimal equity and 10% interest bearing loan with moratorium period of 5 years
- Sub Co has appreciated significantly in value in 5 years and Invest Co proposes to acquire 10% stake at 1000 crs
- Invest Co infuses capital in Sub Co at premium. Sub Co uses the proceeds to pay its debt to ICO

GAAR action:

- AO invokes GAAR on the premise that ICO in substance sold its stake at substantial premium

CS 4B : Externalisation

Issues

- How to compute tax benefit?
- Which event is GAAR tainted since 'arrangement' includes step in or part of arrangement'
  - Funding by way of loan to Sub Co instead of equity
  - Issue of shares to Investor Co?
  - Repayment of Debt?
- Who is assessee who has entered into arrangement for purpose of section 95 – ICO or Sub Co?
- Whether arrangement satisfies main purpose test or tainted element test?

CS 5 : Conversion of Co into LLP

Conversion of Co into LLP

- Section 47(xiiib) provides following tax neutrality conditions:
  - All assets and liabilities of company immediately before conversion become the assets and liabilities of LLP
  - All shareholders of company become partners of LLP and their capital contribution and profit sharing ration in the LLP are in same proportion
  - Shareholders do not receive any consideration other than share in profit and capital contribution in LLP
  - Total sales or turnover in proceeding 3 years does not exceed 60 lakhs
  - Total book value of asset in proceeding three years does not exceed 5 crs
  - No amount is paid to any partner out of accumulated profit for period of three years
- Mumbai Tribunal in Celerity Power LLP 2018] 100 taxmann.com 129 (Mumbai - Trib.) held that non tax compliant conversion of company amounts to transfer but no tax is payable as tranfer is at book value

Conversion of Co into LLP

- Megastar Private Limited (MPL) proposes to covert itself into LLP. Following are key financial parameters:

Particulars	Rs (crs)
Income	
Trading	15
Interest	14
Reserves	**100**
Asset	120

- MPL deploys surplus cash in bank FDs and earns interest which is deployed again as FD

Conversion of Co into LLP

- MPL coverts itself into LLP
- Post conversion following possibilities emerge:
  - Possibility 1: M LLP distributes future profit and interest income to partners
  - Possibility 2: M LLP withdraws capital after 5 years
  - Possibility 3: M LLP withdraws capital in a manner that in each financial year tax benefit to all parties does not exceed 3 crs
- AO invokes GAAR:
  - Possibility 1: Taxing conversion of LLP by substituting fair value as consideration
  - Possibility 2: Treats yearly income distributed by LLP as dividend considering conversion of company into LLP as IAA
  - Possibility 3: Levies DDT on company and tax on shareholders by considering main purpose of transaction as distribution of accumulated reserves

AO Possibility 1: Substituting fair value

- GAAR is part of anti-abuse provision
- It needs to operate within frame work of law. Accordingly, consequences determined by AO also need to operate within framework of law
- Law does not permit substitution of consideration alleged to be received in absence of legislative provisions

AO Possibility 2: Bring future income to tax

- 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
- Arguably, definition of tax benefit does not permit taxation of benefit arising from future income on account of IAA
- Further, if GAAR is invoked in year of conversion, how tax benefit can be computed?

AO Possibility 3: Levy DDT in year of conversion

- Definition of tax benefit is wide enough to include tax deferral
- Further tax benefit may be in relevant previous year or any other previous year
- Rule 11UA provides that GAAR shall not apply to arrangement where the tax benefit in relevant assessment year arising in aggregate to all the parties to the arrangement does not exceed a sum of Rs 3 crs
- If AO simply disregards conversion then he cannot levy DDT since in LLP there is no concept of dividend declared, distributed or paid and accordingly section 115-O nor section 115BBDA is not triggered
- If AO treats as if conversion of company into LLP has not taken place – possibly he may succeed in levy of DDT
- However, in the year in which LLP distributed accumulated profit tax benefit in relevant assessment year does not exceed Rs 3 crs.
    - Can invoke GAAR to contend that transaction is IAA as capital withdrawal is arranged in a manner to take benefit of Rule 11UA and amounts to mis-use of grandfathering provisions

Thank You

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