Impact of India's General Anti-avoidance Rules on transactions

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Overview

In the *Ayodhya Rami Reddy Alla* (the "**Taxpayer**") case, the Telangana High Court (the "**THC**") held that, while considering a tax avoidance device, the proper way to construe a taxing statute is not to ask whether the provisions should be construed literally or liberally, or whether the transaction is real and not prohibited by statute, but whether the transaction is a device to avoid tax and whether it will pass judicial scrutiny. The THC also held that tax planning can be legitimate provided it is within the framework of law, but colourable devices cannot form a part of tax planning. It is the obligation of every citizen to pay taxes honestly without resorting to subterfuge, and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods.

Background

The Taxpayer sold shares of Ramky Estate and Farms Limited ("**REFL**") to Advisory Services Private Limited ("**ASPL**"). Prior to the sale of shares to ASPL, REFL had issued bonus shares to its shareholders in the ratio 5:1. On this basis, the face value of each share of REFL got reduced to one-sixth of its value. The sale of REFL shares to ASPL resulted in a short term capital loss to the Taxpayer that was set off against long term gains made on a different transaction of sale of shares in Ramky Enviro Engineers Limited ("**REEL**"). For the assessment year 2019-20, the Taxpayer filed an income tax return reporting the income under the head "Capital Gains" arising out of the sale of shares of REEL after adjusting the capital loss incurred on the sale of REFL shares and paid the requisite income tax.

The income tax authorities ("**ITA**") contended that the proposed transaction was entered into for: (i) round-tripping of funds; (ii) creating an intentional loss; and (iii) sidestepping tax obligations. The transaction had no commercial substance and, thus, was an impermissible tax avoidance arrangement. Based on this, the ITA issued a notice to the Taxpayer invoking the General Anti-avoidance Rules ("**GAAR**") under Section 96 of the Income-tax Act, 1961 (the "**IT Act**").

GAAR mainly deal with impermissible avoidance arrangements: (a) whose main purpose is to obtain tax benefits by creating rights or obligations that are not ordinarily created between persons dealing at arm's length; (b) resulting, directly or indirectly, in the misuse, or abuse, of the provisions of the IT Act; (c) lacking commercial substance in whole or in part; or (d) entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes. An arrangement shall be presumed to have been entered into or carried out for the main purpose of obtaining a tax benefit unless it is proved to the contrary by the assessee.

The Taxpayer filed a writ petition against the notice for a declaration that the notice was arbitrary and *ultra vires* the IT Act, and on jurisdiction grounds. The Taxpayer argued that the Specific Anti Avoidance Rules ("SAAR") provided in Section 94(8) of the IT Act (commonly referred to as the "bonus stripping provisions") should take precedence over GAAR. Section 94(8) of the IT Act provides that where: (a) a person buys or acquires any units within a period of three (3) months prior to the record date; (b) the person is allotted additional units without any payment on the basis of holding units on such date; (c) the person sells or transfers all or any of the units referred to in clause (a) within a period of nine (9) months after such date, while continuing to hold all or any of the additional units referred to in sub-clause (b), then the loss, if any, arising to him on account of such purchase and sale of all or any of such units shall be ignored for the purposes of computing his income chargeable to tax, and the amount of loss so ignored shall be deemed to be the cost of acquisition of such additional units referred to in sub-clause (b) as are held by him on the date of such sale or transfer. This contention was not accepted by the THC.

THC's ruling

The THC dismissed the writ petition filed by the Taxpayer and held that the ITA had adequate powers to reject the SAAR and instead invoke the GAAR. The THC ruled that the Taxpayer's contention that the bonus stripping provisions should take precedence over GAAR was fundamentally flawed and lacked consistency because the Taxpayer had himself asserted that for the year under consideration, the bonus stripping provisions did not apply to cases involving the shares of a company. This inherent contradiction significantly weakened the overall credibility of the Taxpayer's arguments. In cases where the general provisions are already in force and the special provisions are enacted subsequently, courts have held that the general provisions should not be invoked. Although the specific bonus stripping provision was enacted prior to the GAAR but as the GAAR began with a non-obstante clause, they had an overriding effect on the bonus stripping provision.

Our comments

In this case, the Taxpayer could not provide substantial and persuasive proof to counter the ITA's argument that the entire arrangement was intricately designed with the sole intent of evading tax. This reiterates the principle derived from the *Vodafone* tax case, in which it was, *inter alia*, held that the business intent behind a transaction serves as a strong piece of evidence whether the transaction is deceptive or an artificial arrangement. However, the *Vodafone* judgment places the burden of proof to prove a fiscal misconduct on the ITA. In contrast, the GAAR place the responsibility to disprove the presumption of a tax avoidance scheme on a taxpayer.

The interplay of the GAAR with other anti-avoidance provisions, especially those contained in a double taxation avoidance agreement such as the principal purpose test, the limitation of benefits clause, and the beneficial ownership test, remain a controversial issue. Nevertheless, the THC ruling brings out the importance of having commercial substance, especially in arrangements among group companies. Although GAAR serve as an important

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checkpoint against unethical tax manoeuvring, it is equally important that genuine cases are not blocked by the ITA and the courts.

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