

# Tax Hotline

June 18, 2024

## TELANGANA HIGH COURT DISMISSES TAXPAYERS' CONSTITUTIONAL WRIT CHALLENGING INVOCATION OF GAAR

- The principle of specific provision prevailing over the general, applies exclusively when the general provisions are introduced prior to the specific provisions. Additionally, the court emphasized that GAAR provisions, beginning with a non-obstante clause, would override other provisions of the Act.
- SAAR and GAAR could both be applied depending on the facts and circumstances of each case (as has been clarified by the CBDT in one of its circulars).
- GAAR was introduced to codify, and further enhance the already existing principles of Judicial Anti-Avoidance Rule ('JAAR') (that had developed through Indian jurisprudence on the subject over the years).
- The principle of 'form over substance' must be looked at to arrive at a determination, as to whether the 'intent' of the transaction was to avoid taxes.
- While tax planning may be legitimate within the bounds of the law, colorable devices cannot be accepted as part of tax planning.
- While under the JAARs, the burden of proof to prove any fiscal misconduct was on the Revenue Authorities, the burden under the GAAR provisions is (to the contrary) on the taxpayer.

## THE CASE BEFORE TELANGANA HIGH COURT

The Telangana High Court (Court) recently dismissed a constitutional writ petition<sup>1</sup> challenging the Revenue's invocation of the General Anti-Avoidance Rule (GAAR) under the Income-tax Act, 1961 (ITA) to hold the taxpayer's arrangement as being an 'impermissible avoidance arrangement' (IAA). The taxpayer had allegedly resorted to bonus stripping (i.e., issuance of bonus shares to bring down the per share value) to create artificial losses, which were then set off against long term capital gains arising to the taxpayer. During AY 2019-20, the taxpayer disposed certain shares in Ramky Estate Farms Limited, resulting in short term capital losses (STCL). Interestingly, REFL had issued bonus shares immediately prior to the disposal, resulting in a significant reduction in the value of each share. This reduction contributed heavily to the quantum of STCL, which was subsequently set off against long-term capital gains arising to the taxpayer on another transaction. There was also an intercompany deposit to a related entity, which was subsequently written off from the ledgers in 2019, and was also claimed as a business loss (to offset capital gains).

Consequently, the Revenue purported to invoke GAAR and issued notice under Section 144BA (affording the taxpayer a chance to file objections). Section 144BA sets out a multi-layered mechanism for the Revenue to invoke the GAAR (i.e., it has to first be approved by a Principal Commissioner, and then subsequently confirmed by an Approving Panel constituted by Revenue Officers and a retired judge of a High Court). It is only once this muster is passed, that an arrangement is deemed to an IAA. However, before the proceeding reached the level of the Panel, the taxpayer filed its objections with the Revenue and also challenged the notice (for invocation of GAAR) before the High Court - contending that GAAR could not be invoked on the ground of jurisdiction (as in this instance, an alleged SAAR provision on bonus stripping<sup>2</sup> exists under the ITA, which should have applied instead). However, quite to the contrary, the taxpayer contended that since the language of the SAAR only curbed bonus stripping in the case of 'units', and not 'shares', the taxpayer was protected (and that the SAAR did not apply to the specific facts of this case). [Note: The language of this provision was later amended by the legislature to include 'shares']. The Taxpayer argued that since the SAAR is a specific provision, it impliedly excluded the application of the general provision i.e., GAAR.

## DECISION

The Court dismissed the writ petition filed by the Taxpayer, holding that the argument of special provision prevailing over general is applied exclusively in situations where general provisions are already existing, and special provisions are enacted subsequently. Presently, SAAR was already in place, and GAAR was introduced subsequently, and therefore this argument could not be sustained. Importantly, the Court also highlighted that the GAAR provisions under the ITA began with a non-obstante clause, and would therefore override other provisions of the ITA. To this effect, the Court also relied on a clarification by the Central Board of Direct Taxes, to concur that both SAAR and GAAR could be applied depending on the circumstances of each case.

The Court further noted that GAAR was implemented to formally consolidate and strengthen the underlying principles of the Judicial Anti-Avoidance Rule (JAAR), which had evolved through Indian legal precedents over time.

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Accordingly, the principle of 'form over substance' was emphasized to arrive at a determination, as to whether the 'intent' of the transaction was to avoid taxes. It was pointed out that while under the JAARs, the burden of proof to prove any fiscal misconduct was on the Revenue Authorities, the burden under the GAAR provisions was shifted on the taxpayer. Lastly, the Court noted that the ITA outlines the procedure for applying GAAR, ensuring thorough evaluation of transactions from multiple perspectives to uphold fairness. Accordingly, the Taxpayer's decision to bypass this process and file a writ petition raised questions about its motives. The Court cited the landmark judgment in McDowell<sup>3</sup>, reiterating that while tax planning may be legitimate within the bounds of the law, colorable devices cannot be accepted as part of tax planning.

To this effect, the Court went into the merits of the case and noted that the taxpayer was unable to disprove the clear evidence to suggest that the arrangement was designed with the sole intent of evading taxes. The Court remanded the matter back to the Revenue, to go through the regular process for the invocation of GAAR (i.e., under Section 144BA), which would as a next step have involved the matter being referred to an Approving Panel for the final declaration of the arrangement as an IAA. The Approving Panel is required to grant the Revenue and the Assessee an opportunity to be heard before coming to its final conclusion in this respect. However, in this case, the High Court seems to have exceeded its writ jurisdiction, by commenting on the merits of the case and finding the arrangement to be an IAA (which conclusion should have been made by the Approving Panel). It would appear to be highly unlikely for the Approving Panel to now disagree with the findings of the High Court, while conducting an enquiry into the determination of IAA (which is otherwise their role).

CONCLUSION

While instances of revenue authorities invoking GAAR (as opposed to JAAR) were previously not very common, there is now a noticeable shift in this trend. This is especially relevant given the stand of courts refusing to interfere with such invocation, on account of constitutional writs challenging the same. Therefore, it remains all the more crucial to scrutinize and evaluate arrangements through the lens of the GAAR; and ensure that commercial rationale and economic substance remain key determinative factors for transactions.

Further, while the Court has noted that GAAR and SAAR can both apply based on facts of the case, the dichotomy in its application is yet to be seen in the context of tax treaties (that contain specific SAAR provisions). The question that remains is therefore, where despite meeting the conditions within SAAR provisions (for example, despite meeting the SGD 200,000 spending limit under the India Singapore treaty – and thus not being a conduit company), GAAR could still apply (at an overall level)? The intuitive answer appears to be in the positive – while SAAR acts as a first layer of the muster to counter a specific evil (for example, shell companies), GAAR applies at an overall transaction level (to decipher whether the intent behind the whole arrangement and structure was primarily tax). Thus, despite meeting specific SAAR thresholds within treaties, GAAR could nonetheless apply to find arrangements to be IAAs.

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<sup>1</sup>Ayodhya Rami Reddy Alla vs. PCIT [WP Nos. 46510 and 46467 of 2022 (Telangana High Court)]

<sup>2</sup>Section 94(8) of the ITA

<sup>3</sup>McDowell & Co. Ltd. v. CTO (1985) 3 SCC 230

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