

Telangana HC upholds application of GAAR over SAAR in a bonus-stripping transaction adopted by the taxpayer

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Summary

In a recent case¹, the Telangana High Court (HC) dismissed the writ petitions filed by the taxpayer against the invocation of GAAR² provisions. The taxpayer contended that the transaction is covered under the ambit of SAAR³, and hence, GAAR should not apply.

The HC held that the arrangement was an impermissible avoidance arrangement, as it lacked commercial substance. The HC further held that both GAAR and SAAR provisions could be applied, depending on the facts of each case.

Background

- The taxpayer held the shares of a private limited company⁴. Subsequently, the private limited company issued bonus shares in the ratio 5:1. This led to a reduction in the original face value of the shares of the private limited company to 1/6th of its value.
- Further, the taxpayer sold the shares of the private limited company at the reduced face value, thereby incurring a short-term capital loss. This loss was set off against the long-term capital gain made from another sale of shares.
- During the course of assessment proceedings, the tax officer sought to treat the transactions as 'impermissible avoidance arrangements' as per GAAR, and issued a notice⁵ to the taxpayer seeking objections, if any, to invoke GAAR proceedings⁶.

- The taxpayer responded to the notice by refuting all the allegations. After that, the PCIT⁷ issued a show cause notice seeking a response from the taxpayer on why the transaction undertaken by the taxpayer should not be treated as an IAA.
- A writ petition was filed before the HC, challenging the issuance of the aforesaid notice. The taxpayer has filed the writ petition primarily challenging the applicability of GAAR provisions in the instant case.

Key observations of HC:

SAAR vs. GAAR

- In the instant case, the special provision was already in the Act⁸ and the general provision was subsequently enacted by way of amendment. Normally, the special provision is subsequently enacted. In such circumstances, various courts have held that a special provision takes precedence over the general provision.

¹ Ayodhya Rami Reddy Alla [TS-398-HC-2024(TEL)]

² General Anti-Avoidance Rules under chapter X-A starting from section 95-102 of the Income-tax Act, 1961 (the Act)

³ Specific Anti-Avoidance Rules (section 94(8) of the Act)

⁴ Ramky Estate and Farms Limited

⁵ Under Rule 10UB(1) of the Income-tax Rules, 1962

⁶ Under section 144BA(1) of the Act

⁷ Principal commissioner of Income tax

⁸ Section 94(8) of the Act

Accordingly, the taxpayer's argument was held as untenable.

- GAAR provisions under the Act⁹ begin with a non-obstante clause. Therefore, provisions of this chapter would override the other existing provisions of the Act.
- Before the formal codification of GAAR into law in 2018, the judicial system had already established its own set of 'Judicial Anti Avoidance Rules' known as JAAR. The main features of JAAR are as follows:
 - It operates under the principle of 'substance over form'.
 - It seeks to uncover misleading structures or transactions that lack commercial substance.
 - They are carefully crafted tools designed to scrutinise transactions and financial arrangements that might otherwise escape tax obligations through legal loopholes.
 - They ensured that transactions were conducted transparently and within the spirit of the law.
 - The judiciary's commitment to uphold these principles culminated in the addition of GAAR provisions within the Act.
- The taxpayer's contention that SAAR should take precedence over GAAR is flawed and lacks consistency, as the special provision did not apply to shares during the relevant financial year.
- The committee's¹⁰ stance that SAAR would generally supersede GAAR mainly pertains to international agreements and not domestic cases. The finance minister

had stated that the applicability of either GAAR or SAAR would be determined on a case-by-case basis.

- The CBDT¹¹ has also clarified¹² that both SAAR and GAAR would be applied depending on the specifics of each case.

Lack of commercial substance

- The SAAR provisions¹³ might apply to a simple case of issuing bonus shares with underlying commercial substance. However, in the present case, the issuance of bonus shares was clearly an artificial avoidance arrangement without logical or practical justification.
- The current arrangement is seen as deliberately misusing the Act's provisions, manipulating the law for advantage.
- This arrangement creates extraordinary rights and obligations that appear to lack good faith. These unusual terms do not align with fair dealing principles, indicating it is an impermissible avoidance agreement under the Act¹⁴.
- The Vodafone judgement¹⁵ indicates that business intent can show that a transaction isn't deceptive, burdening the tax officer to prove fiscal misconduct. However, GAAR provisions¹⁶ shift this responsibility to the taxpayer, requiring him to disprove tax avoidance. In this case, clear evidence suggests that the arrangement was designed to evade tax, and the taxpayer has not provided sufficient proof to counter this claim.

⁹ Chapter X-A of the Act

¹⁰ Shome Committee Report, 2012

¹¹ Central Board of Direct Taxes

¹² Circular No 7/2017 dated 27 January 2017

¹³ Section 94(8) of the Act

¹⁴ Section 96 of the Act

¹⁵ Vodafone International Holdings B.V. vs. UOI (2012) 17 taxmann.com 202 (SC)

¹⁶ Section 96(2) of the Act

- The Act¹⁷ outlines the procedure for applying the GAAR provisions, ensuring thorough evaluation of transactions from multiple perspectives. This comprehensive examination upholds fairness at each step. However, the taxpayer bypassed this process by seeking the HC's intervention and raising questions about their motives.
- Tax planning may be legitimate, provided it is within the framework of law.

Colourable devices cannot be a part of tax planning. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.¹⁸.

HC's ruling:

- The tax officer has persuasively and convincingly shown that the transactions in the instant case are not permissible tax avoidance arrangements. Therefore, the GAAR provisions are applicable.

Our comments

This HC judgement marks the beginning of the much-awaited judicial analysis of the complex interplay between the GAAR and SAAR, and one hopes that in the times to come, finer nuances of this interplay will be addressed by the judicial forums.

Amidst the consistent stance of the tax administration justifying the co-existence of GAAR and SAAR, a compelling argument persists that while GAAR can indeed enhance SAAR, the practical application of both the provisions should not overlap in conflict. In many countries, consequent upon a codified GAAR, the judiciary has stopped invoking JAAR to avoid overlapping. In India, there is no certainty on the stand of the judiciary, as of now.

The HC has also made a very interesting observation that while Indian courts have generally adhered to a stand that 'special provisions override general provisions', in cases such as the present one, where the GAAR was enacted subsequent to the enactment of SAAR, these judicial precedents would not apply.

¹⁷ Section 144AB of the Act

¹⁸ McDowell & Co. Ltd. v. CTO [(1985) 3 SCC 230]

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