[2022] 135 taxmann.com 156 (Article)

Date of Publishing: February 14, 2022

Can GAAR Override DTAA?

MAYANK MOHANKA

Senior Partner in M/s S M Mohanka & Associates & Founder Director in Tax Aaram India Pvt. Ltd.

'Can GAAR override DTAA?', or for that matter, 'Can treaty shopping be considered as an impermissible arrangement?'

Well Friends, this seemingly short and pinpointed question, has in-seemingly long and abstract answer, in the absence of any specific legal precedent in this regard, in India, as of now.

However, in this article, I am making an honest and sincere attempt to find a plausible, logical and wellreasoned answer to this complicated question, analysing the applicable provisions of the Constitution of India, the Income Tax Act, 1961, legal precedents in India, though not exactly on this question, and of-course, the recent judgement of the hon'ble Supreme Court of Canada on this specific issue.

The Advent of GAAR- the Backdrop:

The Festival of Colours, Holi is around the corner. Colours represent vibrancy, joy and exuberance in the Holi festival. However, in the Income Tax Act, the expression, "colourable device", is being looked at, in an altogether different manner.

In its landmark judgment, in the case of *McDowell & Co. Ltd.* v. *CTO* [1985] 154 ITR 148/22 Taxman 11, the Hon'ble Supreme Court of India, has held that,

> *"The Tax Planning may be legitimate provided it is within the framework of law. Colourable Devices cannot be part of tax planning..."*

The thin dividing line between "legitimate tax planning" and "illegitimate tax evasion", started getting blurred, after the misinterpretation of the said judgement by the Revenue Authorities, until the Hon'ble Supreme Court, in its another landmark judgement, in the case of "*Union of India* v. *Azadi Bachao Andolan* [2003] 263 ITR 706/132 Taxman 373", again reinforced and reinstated the legal sanctity of the "legitimate tax planning". The Hon'ble Apex Court in this judgement, had observed,

> "We may in this connection usefully refer to the judgement of the Madras High Court in *M.V. Valliappan* v. *ITO* [1988] 37 Taxman 46/170 ITR 238 (Mad.), which has rightly concluded that the decision in McDowell cannot be read as laying down that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement which is perfectly permissible under law, which has the effect of reducing the tax burden of the assessee, must be looked upon with disfavour.....
>
> We may also refer to the judgement of Gujrat High Court in *Banyan & Berry* v. *CIT* [1996] 84 Taxman 515/222 ITR 831, where referring to McDowell, the court observed: "The court nowhere

> said that every action or inaction on the part of the taxpayer which results in reduction of tax liability to which he may be subjected in future, is to be viewed with suspicion and be treated as a device for avoidance of tax irrespective of legitimacy or genuineness of the act; an interference which unfortunately, in our opinion, the Tribunal, apparently appears to have drawn from the enunciation made in *McDowell & Co. Ltd.* (Supra). The ratio of any decision has to be understood in the context it has been made. The facts and circumstances which lead to McDowell's decision leave us in no doubt that the principle enunciated in the above case has not affected the freedom of the citizen to act in a manner according to his requirements, his wishes, in the manner of doing any trade, activity or planning his affairs, with circumspection, within the framework of law, unless the same fall in the category of colourable device which may properly be called a device or a dubious method or a subterfuge clothed with apparent dignity."

Then again in its historic judgement in the case of *"Vodafone International Holdings B.V.* v. *Union of* India" [2012] 17 taxmann.com 202 , the Hon'ble Supreme Court had observed with subtle clarity as under,

> "The department's argument that there is a conflict between *Azadi Bachao Andolan* (Supra) & *McDowell & Co. Ltd.* (Supra) and that Azadi Bachao is not good law is not acceptable. While tax evasion through the use of colourable devices and by resorting to dubious methods and subterfuges is not permissible, it cannot be said that all tax planning is impermissible."

With these landmark judgments, a well settled legal position regarding the re-enforcement of the legal sanctity of the "legitimate tax planning" as against the "use of colourable devices for illegitimate tax evasion", had emerged.

But then came **'General Anti Avoidance Rules'** (more popularly referred to as **'GAAR'**).

A new Chapter X-A, containing GAAR provisions in sections 95 to 102, has been incorporated, in the Income Tax Act. After its deferment in a couple of Finance Acts, probably due to plummeting investors' confidence, finally, it has been made applicable w.e.f. 1.04.2017.

Further a new section 144BA has also been inserted in the Income Tax Act, providing for a reference to be made by the Assessing Officer, to the Principal Commissioner or Commissioner, at any stage of the assessment or reassessment proceedings, having regard to the material and evidence available, on consideration, that it is necessary to declare an arrangement as an impermissible avoidance arrangement and to determine the consequence of such an arrangement within the meaning of Chapter X-A.

A plain reading of the text of sections 95 to 102, contained in Chapter X-A, and section 144BA, in the Income Tax Act, containing GAAR provisions, makes it amply clear, that under the GAAR regime, any arrangement, the main purpose of which is to obtain a tax benefit and which lacks commercial substance, would be considered as an impermissible avoidance arrangement.

The legislative intent behind the introduction of these GAAR provisions, has been to curb the use of colourable devices facilitating tax evasion. The denial of tax benefit in an impermissible avoidance arrangement aimed at tax evasion, is completely justifiable. However, a lot of subjectivity has been somehow, allowed to be crept in, especially, in the manner in which the text of sections 95 to 102, had been drafted. The most significant and crucial aspect, i.e., what would constitute an impermissible avoidance arrangement, has been left to subjective whims and fancies of the Assessing Authorities.

A bare perusal of the text of sections 95 to 102 of the Income Tax Act, containing GAAR provisions, makes it amply clear that very wide and unfettered powers have been given to the Assessing Authorities, to completely disregard the legal form of any arrangement/transaction, and to look into the subjective substance of the transaction, to pierce the corporate veil, to treat capital receipts as revenue receipts, to disallow any treaty benefits, by altering the residence, source, location and taxability of any international transaction, by treating any arrangement as an impermissible avoidance agreement, assuming it to be lacking commercial substance.

Recent Developments

The Apex Body CBDT vide its letter dated 7.4.2021, has notified the composition of the Approving Panel for making references under GAAR as per section 144BA of the Income Tax Act. It has been provided that in situations where assessee objects to notice issued by Pr. CIT/ CIT on receipt of reference from AO for declaring an arrangement as an impermissible avoidance arrangement and determining the consequences thereof and where assessee's explanation is found unsatisfactory, a reference can be made to the Approving Panel. Such Approving Panel consists of: (i) Chairman, who is/ has been judge of a HC, (ii) Member, who is a member of IRS not below the rank of Pr. Chief CIT/ Chief CIT, and (iii) Member, who is an academic/ scholar having special knowledge of direct taxes, business accounts and international trade practice. CBDT has also directed for a secretariat to be set up for the Approving Panel.

Consequently, GAAR Secretariat has been set up at Delhi and the GAAR Approving Panel has been constituted by Department of Revenue's Office Order No. 37/2022 dated 24.1.2022. The Government has notified first GAAR Panel under the chairmanship of Justice Chander Shekhar (Retd. Judge, High Court of Delhi) with Prof. Nigam Nuggehalli, (Registrar, NLSIU Bangalore) and Mr. Rajat Bansal (Pr. Chief CIT) as its members.

The Moot Question: "Can GAAR override 'DTAAs'?

It is a trite law that in determination of tax liability of any assessee in respect of an international transaction, the more beneficial provisions or articles of the Double Taxation Avoidance Agreements (DTAAs), will prevail over the inconsistent provisions contained in the Income Tax Act, as contained in section 90(2) of the Income Tax Act, and as upheld by the recent landmark judgement of the hon'ble Supreme Court, in the case of *"Engineering Analysis Centre of Excellence (P.) Ltd.* v. *CIT"* [2021] 125 taxmann.com 42/281 Taxman 19.

Interestingly, in order to overcome sub-section (2) of section 90, Legislature has inserted another sub section (2A) in section 90 of the Income Tax Act, w.e.f. 1.4.2017.

Section 90(2A) of the Income Tax Act, 1961 states, "Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him."

In other words, this new subsection (2A) in section 90, suggests that in case of an inconsistency between the DTAA and the provisions of Chapter X-A, containing GAAR provisions, the statute shall override the treaty. Consequently, the assessee may be denied tax benefits of the DTAA.

However, whether it is permissible for a domestic legislation to unilaterally override an international treaty?

The Hon'ble Delhi High Court in the case of *'Director of Income Tax v. New Skies Satellite BV', [2016] 68 taxmann.com 8/238 Taxman 577, has comprehensively analysed the issue of whether an amendment* made to a domestic statute can be read into a treaty. It stated that no amendment, whether retrospective or prospective, could be read in a manner that modifies the operation of the terms of an international treaty. Domestic law remains static for the purposes of a DTAA. It held said that while the Parliament may be supreme, it was "simply not equipped with the power to, through domestic law, change the terms of a treaty."

The hon'ble Delhi High Court in this judgement has observed that the provisions of the Vienna Convention on the Law of Treaties, 1969 ('VCLT') were universally accepted as a part of customary international law. Article 39 of the VCLT says that an amendment to a treaty may only be brought about by an agreement between the parties.

The hon'ble Delhi High Court while observing that unilateral amendments are categorically prohibited, has held that,

> "States are expected to fulfil their obligations under a treaty in good faith. This includes the obligation to not defeat the purpose and object of the treaty."

According to the hon'ble Delhi High Court this was a principle rooted firmly in customary international law and could not be breached. Even our Constitution under Article 51(c) endorsed this principle and in light of this, the legislative powers of Parliament were limited.

Relevant Provisions in The Constitution of India

Article 253 of the Constitution of India mandates an important principle dealing with India's international obligations. It reads:

> "Notwithstanding anything in the foregoing provisions of this Chapter, Parliament has power to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body."

Section 90(2) of the Income Tax Act, 1961 is an example of the exercise of this power by the Parliament– an example of a law to implement DTAAs.

While Section 90(2) is an instance when the power under Article 253 has been exercised, Section 90(2A) of the Act is an instance of the exercise of powers under Article 246 along with Entry 97, presumably, of the Union List.

So, a law made in pursuance of Article 246 has been used to override a law made in pursuance of Article 253. The issue is whether this is permissible.

Article 253 contains the phrase, "Notwithstanding anything in the foregoing provisions of this Chapter". The *non-obstante* clause could mean that Article 253 prevails over Articles 245 and 246.

The hon'ble High Court of Andhra Pradesh,in the case of *'Sanofi Pasteur Holding SA v. Deptt. of Revenue*', [2013] 30 taxmann.com 222/213 Taxman 504, followed the decision of the Canadian Supreme Court in '*R.* v. *Melford Development lnc', (1982) 2 SCR 504,* and held that once a law has been enacted under Article 253, every other law is subject to that law. A law made under Article 253 cannot be amended by a subsequent statute, which has been ordinarily made pursuant to the powers conferred under Article 246.

The hon'ble court held that this was necessary to maintain the sanctity of international obligations because otherwise, domestic law would routinely alter the country's international obligations.

Canadian Supreme Court Judgement in "Alta Energy Luxemburg"

On 26.11.2021, the hon'ble Supreme Court of Canada has pronounced its landmark judgement in the case of ***"Her Majesty the Queen v. Alta Energy Luxembourg S.A.R.L., [2020] 116 taxmann.com 856 (FC - Canada)".***

In this judgement the hon'ble Canadian Supreme Court has upheld the availability of tax benefits available to the respondent 'Alta Energy Luxemburg', as per the relevant provisions of tax treaty and has dismissed the Canadian Government appeal. The decision, also limits the application of General Anti-Avoidance Rules by explaining the narrow scope within which it must operate. This decision, being one of the few in this space, is expected to significantly shape the evolution of the General Anti-Avoidance Rules jurisprudence. It is of particular importance in the context of India, which shares the common-law background and the respect for tax treaties, with Canada, in the background of which this decision has been rendered.

Facts of the case: The respondent - Alta Energy Luxembourg was a company incorporated in Luxembourg. It owned shares in Canadian company whose value was derived principally from immovable property based in Canada and which carried on business in such property. Subsequently these shares were transferred by Alta Luxembourg to another entity, which resulted in capital gain in its hands, which was reported in Luxembourg but no tax was paid there as there was no capital gain tax in Luxembourg on such transactions. Alta Luxembourg claimed exemption from payment of capital gains tax in Canada relying upon the Canada-Luxembourg Tax Treaty. It claimed that such class of capital gain was taxable only in the Resident State and not in the Source State under the Tax Treaty and, thus, claimed exemption in Canada under the Tax Treaty. The Canadian Tax Authorities (represented by the" Minister") rejected the claim. According to the Minister, the exemption claim of Alta Luxembourg under the Tax Treaty could not be counterstained because Canadian GAAR applied to the transaction and, thus, the exemption was to be annulled. Both the Tax Court of Canada and Federal Court of Appeal disagreed with the Minister. Their stand was challenged by the Minister in further appeal before the SCC.

Decision of the Canadian Supreme Court: The decision of the Supreme Court of Canada, by a 6-3 majority, was in favour of Alta Energy Luxembourg. The majority rejected all the points canvassed by the Minister. In the Majority's view, inter alia, the arguments of the Minister effectively amounted to rewriting the provisions of the Tax Treaty through the invocation of General Anti Avoidance Rules, which attempt was to be scuttled as it was fundamentally at odds with the larger principles of "certainty and predictability" and also resulted into "fundamentally altering the criteria under which a person is entitled to the benefits" of the Tax Treaty.

The hon'ble Canadian Supreme Court has held that, the overarching principles of public international law continue to limit the ability of a country to unilaterally amend the treaty provisions. According to the SCC, pursuant to the principle of pacta sunt servanda, parties to a treaty must keep their sides of the bargain and perform their obligations in good faith owing to which treaty partners do not have the unfettered liberty to alter or redefine residence as they wish for the purposes of a tax treaty. Put differently, even GAAR cannot be the reason to rewrite or amend tax treaty provisions.

Limitation of Benefits Clause in DTAAs

The Limitation of Benefits clause is a special anti-avoidance rule (SAAR) or provision, which include ensuring treaty benefits are restricted to genuine residents of the other treaty country. Limitation of Benefits clauses may either be subjective, such as main purpose or bona fide tests, or objective, such as minimum investment requirements.

Following the judgement of hon'ble Supreme Court in '*Azadi Bachao Andolan'* (supra), several new and renegotiated treaties including those with UK, USA and Singapore and now Mauritius have seen the introduction of Limitation of Benefits clauses.

The Limitation of Benefits clause in the India-Mauritius tax treaty contains an objective as well as subjective test. The subjective test states that treaty benefits may be denied if the assessee's affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention. In case an arrangement is primarily for commercial purposes it would be permissible and the fact that it incidentally results in tax benefits would be immaterial.

However, as per section 96(2) of the Income Tax Act, even if a part of the arrangement was designed to obtain a tax benefit, it would be hit by GAAR. While the primary purpose of the entire arrangement may be commercial, the arrangement could be presumed to be impermissible.

The PARTHASARATHY SHOME COMMITTEE, (more popularly known as "the Shome Committee" in its *Final Report on General Anti-Avoidance Rules in Income Tax Act, 1961*, 49 (2012), on the issue of Interplay of GAAR and DTAAs, has categorically observed that the Limitation of Benefits clause should take precedence over the GAAR as it is a special law. As per the principle of interpretation, *lex specialis derogat legi generali*, the special law overrides the general. Consequently, in case of transactions covered by the Limitation of Benefits clause, GAAR should not apply. This is also standard practice in other jurisdictions that have GAAR.

Key Takeaways:

The above threadbare analysis of the interplay between GAAR and DTAA, bring to home, the undermentioned key take-a ways:

(*i*) Section 90(2A) of the Income Tax Act, (as conferred by Article 246 of the Constitution of India), can't override section 90(2) of the Income tax Act, (as conferred by Article 253 of the

Constitution of India). Once a law has been enacted under Article 253, every other law is subject to that law. A law made under Article 253 cannot be amended by a subsequent statute, which has been ordinarily made pursuant to the powers conferred under Article 246. It is necessary to maintain the sanctity of international obligations because otherwise, domestic law would routinely alter the country's international obligations.

(*ii*) Parties to a treaty must keep their sides of the bargain and perform their obligations in good faith owing to which treaty partners do not have the unfettered liberty to alter or redefine residence as they wish for the purposes of a tax treaty. Put differently, even GAAR cannot be the reason to rewrite or amend tax treaty provisions.

(*iii*) The provisions of the Vienna Convention on the Law of Treaties, 1969 ('VCLT') are universally accepted as a part of customary international law. Article 39 of the VCLT says that an amendment to a treaty may only be brought about by an agreement between the parties. States are expected to fulfil their obligations under a treaty in good faith. This includes the obligation to not defeat the purpose and object of the treaty.

(*iv*) Any amendment to a treaty may only be brought about by an agreement between the concerned parties, such as by way of including 'Limitation of Benefits Clause' in the renegotiated treaties. The purpose and object of the treaty can't be defeated by bringing in some unilateral domestic legislation including GAAR.

(*v*) The 'Limitation of Benefits Clause', being a 'Special Anti Avoidance Rule (SAAR), should prevail over 'General Anti Avoidance Rule' (GAAR), based on the principle of "*lex specialis derogat legi generali".*

(*vi*) In view of the growing international consensus on the OECD Pillar One and Pillar Two Action Plans, unilateral measures such as GAAR, in any case, are bound to lose their recognition and relevance, in determination of tax liability on international transactions.

Parting Views

For Assessing Authorities:

The application of GAAR provisions, by the concerned assessing authorities, should be made, in accordance with the time tested and well settled legal position of legitimacy of tax planning, within the four corners of law, without the use of any colourable device.

For Assessees

The respected judge **Lord Tomlin**, in the historical judgement of 'Inland Revenue Commissioners v. **Duke of Westminster'** [1936] A.C. 1;[1] 19 TC 490, has said that,

> *"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 this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax."*

But at the same time, in another historical judgement, **'W. T. Ramsay Ltd. v. Inland Revenue Commissioners,** reported in [1982] A.C. 300, it has been held, that if a transaction had pre-arranged artificial steps that served no commercial purpose other than to save tax, the proper approach was to tax the effect of the transaction as a whole.

So, the key to succeed, is to maintain a fine balance between the "Duke of Westminster/Azadi Bachao Andolan" and "Ramsay/Mc Dowell".

So, Friends, do enjoy your Holi, with lots of vibrant Colours, but yes, don't use 'Colourable devices' in your tax affairs.

The Final Conclusion:

"GAAR SHOULD NOT AND CANNOT OVERRIDE DTAA".