Exploring Provisions

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GENERAL ANTI-AVOIDANCE RULE (GAAR) – SUBSTANCE OVER FORM PRINCIPLE BY DESIGN - GUARD AGAINST ABUSE AND MISUSE OF INCOME TAX ACT PROVISIONS © reserved

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PREFACE

With the increasing globalization of economies and growth in cross border transactions, some countries have introduced legislation which has empowered the Revenue Authorities to question transactions and arrangements and disregard their form to deny tax benefit unless the taxpayer can establish the commercial legitimacy of the transaction. However, different countries have taken different approaches in this regard. Australia was in the forefront of introducing a GAAR as early as 1981. Mature economies like Canada, New Zealand, Germany, France and South Africa have also introduced a GAAR. Emerging economies have also started introducing GAAR with the phenomenal growth of their economies. India is behind Australia and Canada in terms of delay in introducing GAAR by 32 and 25 years respectively and any further postponement in its implementation could hit the country hard with many more Vodafone like cases escaping through the tax net and increasing deficits will continue to break common man's bones and pierce their pockets.

Purpose of this Document

GAAR has been hitting the headlines that its implementation will have a negative impact on the market but do we know how? This document provides an initial study of GAAR and its impact in simple terms.

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Quotes:

- It is relatively straight forward to set out the GAAR scheme. It is much more difficult to apply it. Rothstein J. in Copthorne case 2011 SCC 63, [2011] 3 S.C.R. 721
- Gaar is subjective & gives arbitrary powers to tax authorities: R V Kanoria, Ficci, Economic Times, ET Debate , Jul 20, 2012, 05.14AM IST
- In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning. (Government of India)

1. INTRODUCTION:

India has introduced a separate chapter on GAAR to deal with aggressive tax planning. These provisions give Indian tax authorities the right to investigate any arrangements and, if the same is deemed to be for the purposes of tax avoidance, ignore them for tax computation purposes. The basic principle of GAAR is "substance over form".

The Finance Act prescribes four tests for deciding an agreement to be "impermissible avoidance agreement". Satisfying one of the four tests is enough to qualify an agreement to be impermissible. The tests are

- The arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length.
- It results in misuse or abuse of provisions of tax laws.

- It lacks commercial substance or is deemed to lack commercial substance.

- Is carried out in a manner, which is normally not employed for bonafide purpose

2. Dealing sections -Sections 95-102

95to102.docx

ANNEXURE 1

3. Guidelines

Draft_Guidelines_GAAR.pdf

ANNEXURE 2

4. Supplementary memorandum explaining the official amendments moved in the Finance Bill, 2012, as reflected in the Finance Act, 2012- Board Circular Explanatory No. 3 dated 12.6.2012

Board Explanatory Circular 3 dated 12.6.2012- A Clarification

(i) On the prime questions, 1. '*Was There a Tax Benefit? 2. Was the arrangement/ Transaction Giving Rise to the Tax Benefit an impressible Avoidance arrangement/Transaction?', the AO has to discharge the onus of proof or to demonstrate that* obtaining the tax benefit was the main purpose of the arrangement or for that matter that there is an impermissible avoidance arrangement while the assessee has to refute such a presumption and to show that it suffers from palpable and blatant errors. In nutshell the onus of proof will be on the Revenue for any action to be initiated under GAAR.

(ii) To introduce an independent member in the GAAR Approving Panel, one member of the approving panel would be an officer of the level of Joint Secretary or above from the Ministry of Law.

(iii) Any taxpayer (resident or non-resident) can approach the Authority for Advance Rulings (AAR) for a ruling as to whether an arrangement to be undertaken by him is an impermissible avoidance arrangement under the GAAR provisions. The reference can be filed on any date on or after April 1, 2013 to seek an advance ruling regarding an arrangement to be undertaken.

(iv) In order to provide more time to both taxpayers and the tax administration to address the issues arising from GAAR provisions so that there is clarity and certainty in the matter, it is proposed to defer the applicability of the GAAR provisions, proposed in Chapter X-A and section 144BA of the Act, by one year so that they would now apply to income chargeable to tax in respect of assessment year 2014-15 and subsequent years.

5. Understanding the GAAR Effect

5.1 Vodafone Abstracts- Indian Scene

5.2 Copthorne Abstracts- Canada Scene

it is important to be clear why a GAAR is necessary. Not
all countries have them, and not all GAARs are the same. There is no international norm for the GAAR or the need for one.

The need for a GAAR should shape its form and administration. Inevitably GAARs have significant and disciplinary consequences when applied. The GAAR provisions are like a double-edged sword and would need to be judicially invoked by the revenue authorities so that they are designed to address real mischief only and go no further. To ensure the tax system does not fall into disrepute, GAARs must be administered transparently and with abundant due process commensurate with their often draconian consequences

5.1 Vodafone Abstracts- Indian Scene

Vodafone Case- Acquisition of Business with abuse of statute provisions- Supreme Court of India Ruling

The Supreme Court of India in Vodafone International Holdings B. V. v. Union of India (2012) 341ITR1 while running through the DTC scheme observed that GAAR intends to prevent tax avoidance, what is inequitable and undesirable. In this case the Apex Court was concerned with the concept of GAAR for the subject transaction therein satisfied the following three parameters for invoking GAAR in this case:

1. That there was a tax benefit arising from an arrangement/ part of the whole arrangement /transaction or series of transactions as per s.102 (11) of the present Act read with section 102 (1);

2. That the transaction or part or step in the whole of series of transaction or arrangement that give rise to such tax benefit are an "impermissible avoidance arrangement" as described in sub-section 96 of the *Income Tax Act, 1961*; and
3. That such tax benefit results in an abuse of the provisions of s. 9, 45,195 of the Act.

In the absence of GAAR provisions and further in the absence of look through provisions (indirect transfer) in section 9 the Apex Court had to hold in favour of the assessee. The Apex Court at the same time has no two thoughts on the need for GAAR legislation for India as it commented the following in their judgment (Page 83) :-

"Need for Legislation:

54. Tax avoidance is a problem faced by almost all countries following civil and common law systems and all share the common broad aim that is to combat it. Many countries are taking various legislative measures to increase the scrutiny of transactions conducted by non-resident enterprises. Australia has both general and specific anti-avoidance rule (GAAR) in its Income Tax Legislations. In Australia, GAAR is in Part IVA of the Income Tax Assessment Act, 1936, which is intended to provide an effective measure against tax avoidance arrangements. South Africa has also taken initiative in combating impermissible tax avoidance or tax shelters. Countries like China, Japan etc. have also taken remedial measures."

In other words if GAAR provisions were there at that
time and further even if the Income tax Act had not contained look through clause in section 9 Vodafone would have had no escape. Now even after section 9 is amended from back date there is little that the revenue could do in the absence of retrospective effect of GAAR provisions. The Apex Court also pointed out that lack of clarity and absence of appropriate provisions in the statute regarding the circumstances in which judicial anti-avoidance rules would apply has lead to litigation. At the same time the Court was upbeat on the fact that holding Structures are recognized in corporate as well as tax laws and special Purpose Vehicles (SPVs) and Holding Companies have a place in legal structures in India, be it in company law, takeover code under SEBI or even under the income tax law. What is desirable for GAAR implications is that at the threshold, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s).

In Vodafone case the Revenue had no help of GAAR provisions as they had not come into force then in which case it was desirable for them to invoke the "substance over form" principle or "piercing the corporate veil" test. In this case the revenue failed to prove at the threshold that the arrangement lacked commercial/business substance or for that matter that the impugned transaction was a sham or tax avoidant being entered only to avoid tax. The revenue went on to look through on the form of the transaction in a piece meal manner rather than to look at the substance of the entire series of transactions. The revenue failed to establish that at any stage there was no commercial substance or for that matter that the transaction was meant to avoid taxes by abuse to the provisions of the Act.

5.2 Copthorne Abstracts- Canada Scene

Copthorne Holdings PUC (Paid up capital) Case- Corporate Reorganization and Surplus Stripping - avoidance of Withholding tax on deemed dividend – Supreme Court of Canada

Facts of the case

Capthorne case Facts.docx

ANNEXURE 3

On December 16, 2011 the Supreme Court of Canada (SCC) released its decision in *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63 (*Copthorne*). *Copthorne* involved the application of the General Anti-Avoidance Rule, or as it is commonly referred to as 'GAAR'.

GAAR applies to deny the tax benefit of a transaction or series of transactions despite the fact that the taxpayer seems entitled to the tax benefit on a technical reading of the relevant legislation. In order for GAAR to apply the following three requirements must be met as per the Supreme Court:

1. a tax benefit must arise from a transaction or series of transactions;
2. the transaction or series of transactions must be an "avoidance transaction" as defined in sub-section 245(3) of the *Income Tax Act of Canada*; and

3. the tax benefit must be a misuse or abuse of the relevant provisions of the tax legislation.

In *Copthorne* the SCC found that all three elements required to apply GAAR had been satisfied and hence it denied the tax benefit of the series of transactions. *Copthorne arrangement* involved a horizontal amalgamation of two sister corporations and subsequent redemption of shares by the parent company. The series of transactions under the arrangement was structured in such a way that the "paid up capital" of the redeemed shares exceeded the original investment with the result that the redemption of the shares did not trigger any tax. This case was a merger between parent and subsidiary. Now in order to avoid cancellation of shares the investments in subsidiary was sold before amalgamation at nominal price and the loss incurred is set off against capital gains realised in amalgamating companies. The corporate law required that on amalgamation any paid up capital (PUC) of the shares of an amalgamating corporation, where its shares were held *by* another amalgamating corporation, will be cancelled rather than being aggregated. So the assessee in this case instead of going for cancellation protected those many shares and later redeemed them at par without paying any deemed dividend tax on the difference between the acquired price and redemption value. The Court went on to hold that the payments to shareholders from an amalgamated corporation on a share redemption should not be taxable as a deemed dividend, only to the extent that such payments reflect investments made with tax-paid funds. Further the corporate law provisions points against preservation of the shares of a subsidiary corporation upon amalgamation of the parent and subsidiary as such preservation would permit shareholders, on a redemption of shares by the amalgamated corporation,

to be paid amounts as a return of capital without liability for tax, in excess of the amounts invested in the amalgamating corporations with tax-paid funds. In this case by parking equity in subsidiary prior to amalgamation the parent managed to protect cancellation and further on redemption what it actually paid is moré that what one invested out of its tax paid funds and therefore the excess paid acquired the character of deemed dividend. It was further held that the redemption transaction was part of the same series as the prior sale and amalgamation, and that the series, including the redemption transaction, resulted in the tax benefit.

The SCC found that under the above arrangement:

1) There was a tax benefit;
2) The series of transactions included a transaction that was an avoidance transaction; and
3) The tax benefit was a misuse or abuse of a provision of the *Income Tax Act*.

Of particular note is that the SCC found that it is not enough that a transaction is a misuse or abuse of tax policy. The misuse or abuse must be tied to a specific provision or provisions.

GAAR provisions have more to do with transactions within the group especially transactions between holding and subsidiary companies or among sister entities who have common ownership.

Abusive tax avoidance

Situation 1:

Where the transaction achieves an outcome the statutory provision was intended to prevent;

Situation 2:

Where the transaction defeats the underlying rationale of the provision;

Situation 3:

Where the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose.

And these considerations are not independent of one another and may overlap.Thus if any transaction is found to be abusive the assessment based on application of the GAAR would be appropriate. The three questions to be decided in a GAAR analysis:

1. Was there a tax benefit?

2. Was the transaction giving rise to the tax benefit an avoidance transaction? ; and

3. Was the avoidance transaction giving rise to the tax benefit abusive or not for bona fide purpose or lacks commercial substance/business purpose or not at arm's length/unusual in nature?

Rationale of GAAR explained by SC

On the question whether the Avoidance Transaction that Give Rise to the Tax Benefit is Abusive the SCC held that taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see Duke of Westminster). It then went on to observe as under:

1. The GAAR is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer. While the taxpayer's transactions will be in strict compliance with the text of the relevant provisions relied upon, they may not necessarily be in accord with their object, spirit or purpose. In such cases, the GAAR may be invoked. The GAAR does create some uncertainty for taxpayers. Courts, however, must remember that s. 245 was enacted "as a provision of last resort" (*Trustco*, at para. 21).
2. A court must be mindful that a decision supporting a GAAR assessment in a particular case may have implications for innumerable "everyday" transactions of taxpayers. A decision affecting PUC is a good example. There are undoubtedly hundreds, and perhaps thousands of share transactions each year in which the PUC of a certain class of shares may be a relevant consideration. Because of the potential to affect so many transactions, the court must approach a GAAR decision cautiously. It is necessary to remember that "Parliament must . . . be taken to seek consistency, predictability and fairness in tax law" (*Trustco*, at para. 42). As this Court stated in *Trustco*:

Parliament intends taxpayers to take full advantage of the provisions of the *Income Tax Act* that confer tax benefits. Indeed, achieving the various policies that the *Income Tax Act* seeks to promote is dependent on taxpayers doing so. [para. 31]

3. For this reason, "the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear" (*Trustco*, at para. 50). The court's role must therefore be to conduct an objective, thorough and step-by-step analysis and explain the reasons for its conclusion.
4. In order to determine whether a transaction is an abuse or misuse of the Act, a court must first 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" (*Trustco*, at para. 55). The object, spirit or purpose of the provisions has been referred to as the "legislative rationale that underlies specific or interrelated provisions of the Act" (V. Krishna, *The Fundamentals of Income Tax Law* (2009), at p. 818).
5. The object, spirit or purpose can be identified by applying the same interpretive approach employed by this Court in all questions of statutory interpretation — a "unified textual, contextual and purposive approach" (*Trustco*, at para. 47; *Lipson v. Canada*, 2009 SCC 1, [2009] 1 S.C.R. 3, at para. 26). While the approach is the same as in all statutory interpretation, the analysis seeks to determine a different aspect of the statute than in other cases. 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 a GAAR analysis the textual, contextual and purposive analysis is employed to determine the object, spirit or purpose of a provision. Here the meaning of the words of the statute may be clear enough. The search is for the rationale

that underlies the words that may not be captured by the bare meaning of the words themselves. However, determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.

6. Second, a court must consider whether the transaction falls within or frustrates the identified purpose (*Trustco*, at para. 44). As earlier stated, while an avoidance transaction may operate alone to produce a tax benefit, it may also operate as part of a series of transactions that results in the tax benefit. While the focus must be on the transaction, where it is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is a part and the overall result that is achieved (*Lipson*, at para. 34, *per* LeBel J.).
7. The analysis will then lead to a finding of abusive tax avoidance: (1) where the transaction achieves an outcome the statutory provision was intended to prevent; (2) where the transaction defeats the underlying rationale of the provision; or (3) where the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose (*Trustco*, at para. 45; *Lipson*, at para. 40). These considerations are not independent of one another and may overlap. At this stage, the Minister must clearly demonstrate that the transaction is an abuse of the Act, and the benefit of the doubt is given to the taxpayer.

8. When applying this test, there is no distinction between an "abuse" and a "misuse". Instead, there is a single unified approach (*Trustco*, at para. 43). In the balance of these reasons, I will therefore only use the term "abuse".

Tests of abusive tax avoidance:

In their final it held that abusive tax avoidance results : (1) where the transaction achieves an outcome the statutory provision was intended to prevent; (2) where the transaction defeats the underlying rationale of the provision; or (3) where the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose. These considerations are not independent of one another and may overlap. At this stage, the AO must clearly demonstrate that the transaction is an abuse of the Act, and the benefit of the doubt is given to the taxpayer.

Key principles on GAAR Derived

Principle of implied exclusion vs. underlying rationale or object, spirit and purpose of the legislation

The assessee may argue that if its actions are not caught by a provision under the tax statute or in other words the law does not so provide for the same as impermissible, such actions cannot abuse the purpose of the provision. In other words the argument is that "there is reason to believe that if the legislature had meant to include a particular thing within its legislation, it would have referred to that thing expressly. However the Court felt that this provision has its limitations in GAAR analysis where the

AO if invokes the GAAR, he concedes that the words of the statute do not cover the series of transactions at issue. Rather, he argues that although he cannot rely on the text of the statute, he may rely on the underlying rationale or object, spirit and purpose of the legislation to support his position.

To maintain consistency between corporate law and tax law

Under the corporate law, shares held by one amalgamating corporation in another are cancelled to prevent an inappropriate dilution of the shares of a corporation upon amalgamation. The Court insisted that it is desirable to maintain consistency between corporate law and tax laws and one cannot get away by stating that the two Acts are independent as the underlying purpose of the corporate law provision cannot be ignored.

6. **Canada Trustco Mortgage Co., v. The Queen, 2005 DTC 5523, 2005 SCC 54**

McLachlin C.J. and Major J. stated (at para. 20):

If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. For example, characterization of an amount as an annuity rather than as a wage, or as a capital gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements. In all cases, it must be determined whether the taxpayer reduced, avoided or deferred tax payable under the Act.

Tax purpose- to be sole or primary purpose

The SCC in providing a clarification on the term sole purpose or primary purpose held that in a given situation the purchase of shares may have a tax purpose, but that does not necessarily mean that the tax purpose will always be the primary reason for the transaction. In the numerous share transactions taking place each year, the party acquiring shares of a corporation will likely be aware of the tax implications. However, where a transaction takes place primarily for a non-tax purpose, there will be no avoidance transaction. In the absence of an avoidance transaction, the fact that a transaction may have a secondary tax benefit purpose will not trigger the GAAR. Whether the transactions are between parties at arm's length or not at arm's length should be immaterial. (*Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536).

On the application of GAAR in corporate reorganization the Court held that there is no general principle against corporate reorganization. Where corporate reorganization takes place, the GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, the GAAR may still not apply. It is only when reorganization is primarily for a tax purpose *and* is done in a manner found to circumvent a provision of the *Income Tax Act* that it may be found to abuse that provision. And it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR.

In the Vodafone case the revenue argued that the charging Section should be construed purposively and it contains a look through provision and that the

definition of the transfer in Section 9(1)(i) is an inclusive
definition meant to explain the scope of that Section and not to limit it The Supreme Court however did not chose to go by the purposive interpretation of section 9 and it rather went by the textual interpretation or legal interpretation in the absence of GAAR provisions in the Act. The Apex Court held that income accruing or arising to a non-resident outside India on transfer of a capital asset situate in India is fictionally deemed to accrue or arise in India, which income is made liable to be taxed by reason of Section 5(2)(b) of the Act. This is the main purpose behind enactment of Section 9(1)(i) of the Act. We have to give effect to the language of the section when it is unambiguous and admits of no doubt regarding its interpretation, particularly when a legal fiction is embedded in that section. A legal fiction has a limited scope. A legal fiction cannot be expanded by giving purposive interpretation particularly if the result of such interpretation is to transform the concept of chargeability which is also there in Section 9(1) (i), particularly when one reads Section 9(1)(i) with Section 5(2) (b) of the Act.

7. Controversies

In regard to application of GAAR provisions the guidelines clarify that the provisions of GAAR will apply to the income accruing or arising to the taxpayers on or after 01.04.2013. On the contrary GAAR provisions should be limiting their application to an arrangement or part of the arrangement coming into effect from 1.4.2013.

8. Transactions susceptible to GAAR

1. Complex set of transactions among entities in a group;
2. Abuse of section 2 (22) (e) or deemed dividend provisions by splitting the shareholdings among related persons
3. Reorganisation and restructuring corporate structure
4. Transfer of shares at nominal price

Reference can be made to guidance circular on GAAR under Canadian Law with examples of misuse abuse of provisions of law.

Guidance Circular on GAAR under Canadia

ANNEXURE 4

9. Black Spots

Business decisions are made on a real-time basis. If the revenue department were to sit on judgment in hindsight, it would introduce considerable uncertainty.

One of the main worries with GAAR, in its present form, is that the onus is on the assessee to prove that tax benefit is not the main purpose of an impugned arrangement. An anti-abuse provision that shifts the burden of proof on the assessee goes against the fundamental principle of 'innocent unless proven guilty'.

The guidelines of June Twenty Twelve indicate an 'arrangement' to be an 'impermissible avoidance arrangement' if,

(a) its main purpose is to obtain a 'tax benefit', and,

(b) it also has one of the following characteristics:

(i) it creates rights and obligations, which are not normally created between parties dealing at arm's length;

(ii) it results in misuse or abuse of the provisions of the tax law;

(iii) it lacks commercial substance;

(iv) it is carried out by means or in a manner which is normally not employed for an authentic (*bona fide)* purpose.

In regard to the first scenario the Income tax Act, 1961 already has transfer pricing scrutiny provisions so that having a clause like (i) above is duplication. Further a situation as one in clause (iii) or (iv) above viz. lack of commercial substance or bona fide is something that which will give hand in glove to the AO to harass the assessee and further two sounds almost similar.

The test of commercial substance or commercial purpose is tried out in Canada domain but did not exceed. The business purpose restrictions were abandoned in response to growing concerns that business purposes were not the only non-tax purposes that could be relevant for undertaking certain transactions. Thus, the test became in their case " primarily fort bona fide purposes other than to obtain the tax benefit". In the same stream our definition of impressible arrangement in section 96 there is also clause (c) in sub-section (1) that refers to an arrangement to be an impressible if it lacks commercial substance. This certainly means assumes that if an arrangement has no substantial business purpose or commercial substance it would be deemed to be one meant to obtain a tax benefit. Similarly under clause (a) of subs-section (1) of s. 96 if an arrangement is not at arm's length it would be one which is impermissible which again is a distant assumption. For instance an arrangement may have substantial commercial purpose yet since it is not an arm's length deal would make it as impressible. There are thus bound to be complexities in the application of the commercial substance rule or on the rule of dealing at arm's length. In the Canadian model therefore GAAR application is limited to avoidance arrangement that result in an abuse or misuse of the provisions of the Act.

Section 92 is somewhat getting into place McDowell principle (McDowell and Co. Ltd. v. CTO- 154ITR148) on tax avoidance/evasion. While upholding their previous verdict in Union of India v. Azadi Bachao Andolan (2004) 10 SCC 1 the Apex Court in Vodafone International Holdings B. V. v. Union of India (2012) 341ITR1 explained the McDowell principle in the following (Pg 34):

" The majority judgment in McDowell held that "tax planning may be legitimate provided it is within the framework of law" (para 45). In the latter part of para 45, it held that "colourable device cannot be a part of tax planning and it is wrong to encourage the belief that it is honourable to avoid payment of tax by resorting to dubious methods". It is the obligation of every citizen to pay the taxes without resorting to subterfuges. The above observations should be read with para 46 where the majority holds "on this aspect one of us, Chinnappa Reddy, J. has proposed a separate opinion with which we agree". The words "this aspect" express the majority's agreement with the judgment of Reddy, J. only in relation to tax evasion through the use of colourable devices and by resorting to dubious methods and subterfuges. Thus, it cannot be said that all tax planning is illegal/illegitimate/impermissible. Moreover, Reddy, J. himself says that he agrees with the majority. In the judgment of Reddy, J. there are repeated references to schemes and devices in contradistinction to "legitimate avoidance of tax liability" (paras 7-10, 17 & 18). In our view, although Chinnappa Reddy, J. makes a number of observations regarding the need to depart from the "Westminster" and tax avoidance – these are clearly only in the context of artificial and colourable devices. Reading McDowell, in the manner indicated hereinabove, in cases of treaty shopping and/or tax avoidance, there is no conflict between McDowell and Azadi Bachao or between McDowell and Mathuram Agrawal."

In nutshell what is held in McDowell case is a check on abuse of the A P sales tax provisions by means of an amicable arrangement. In this case the liability for payment of excise duty was discharged directly by the purchaser on behalf of the manufacturer. According to normal commercial practice, excise duty should have been reflected in the bill either: as merged in price or being shown separately. The sales tax authorities thus included in the turnover of the manufacturer, the excise duty which was not charged by it, but was paid directly to the excise authorities by the buyers of the liquor and levied sales tax on the gross amount including excise duty. In other words there was an abuse of the provisions of the sales tax Act by an arrangement whereby excise duties were paid directly by the purchases whereas the primary liability falls upon the manufacturer.

In other words if there is abuse of any Income tax provisions such as evading liability under deeming provisions, evading liability under deemed transfer provisions etc. by working out an arrangement or transactions then GARR would find application.

It is thus desirable to omit clauses (a) , (c) and (d) from sub-section (1) of section 96 as these would only complicate the matter and further provide unwanted powers to the AO to call every second contract as impermissible arrangement. He is however required to straight put a case of misuse or abuse of any tax provision before holding an arrangement to be impermissible rather than holding an arrangement as impermissible for any tax benefit earned by the assessee.

There is thus an urgent need to rework out the GAAR provisions by putting the cart (tax benefit and tax abuse) before the horse (impermissible avoidance arrangement). If there is no abuse/misuse of any Income tax Act/Rules or treaty provisions there should be reason to obstruct the transaction or arrangement for mere reason that it is not at arm's length or that it lacks commercial substance or is unusual or for that matter it lack the bona fide purpose.

Recent Decision of Bombay High Court

Recently in AVM Capital Services Private Limited the
Bombay High Court in Company Scheme Petition N0. 670/2011 dated 12th July 2012 held that the decision in McDowell's case cannot be read as laying down that every attempt at tax planning is illegitimate, or that every transaction or arrangement which is perfectly permissible under the law, but has the effect of reducing the tax burden of the assessee must be looked upon with disfavor. In this the scheme involves –

(i) The merger of Transferor Companies (Five Nos) with Transferee Company;

(ii) The consequent cancellation of the shares held by the Transferor Companies in the Transferee Company;

(iii) The consequent reduction in share capital of the Transferee Company;

(iv) issuance of shares of the Transferee Company to the shareholders of the Transferor Companies.

The purpose of the Scheme so to say is to provide long term stability and transparency in the Transferee Company. The Transferor Companies are in existence since 1975. It was felt that it would be in the interest of the Transferee Company to merge the five Transferor Companies with the Transferee Company, and to enable the Promoter thereof to hold shares directly in the Transferee Company rather than indirectly. The object of the Scheme is not to avoid any tax. Even today the shares are owned/controlled by the same Promoter albeit through the Transferor Companies. Under the Scheme the only difference is that the Promoter will now hold shares directly in the Transferee Company. The Court held a view that

there is nothing illegal or unlawful or dubious or colourful in the Scheme and the same is a perfectly legitimate scheme and permissible by law.

In this case in the balance sheet of transferor companies there were no capital assets such as immovable property and the the only assets (apart from cash and bank balance) of the Transferor Companies were the shares held by them in the Transferee Company. Had they been there the scheme may have turned into an impermissible arrangement in this case under the GAAR provisions as it would have amounted to abuse of the provisions of section 45.

10. GAAR and treaty override

OECD Model Convention

The 2010 Commentary (Commentary) to Article 1 of the OECD MC discusses the

relationship between domestic anti avoidance rules and treaty and whether treaties benefits would be available with respect to abusive transactions. It clarifies that apart from the principal purpose of tax treaties which is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons, ***prevention of tax avoidance and evasion*** is also a purpose.

The relevant extracts of the Commentary to Article 1 are reproduced below:

The Commentary raises two fundamental questions:

1. Whether the benefits of tax treaties must be granted
when transactions that constitute an abuse of the provisions of these treaties are entered into; and

2. Whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax treaties.

Approach 1

For many States the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions.

Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the second question above.... the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. ***Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions***.43*

Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).44**

43 Extract from para 9.2 of Article 1 of the Commentary*

*44** Extract from para 9.3 of Article 1 of the Commentary*

10.1 What India Inc should watch out for

Aug 4, 2012, 05.28AM IST TNN [LUBNA KABLY]

The government is likely to push for the passing of the Direct Tax Code Bill (DTC Bill). The moot question is, will tax treaties entered into by India be sacrosanct? Or will GAAR provisions over-ride tax treaties. This is of much interest not only to FIIs but the entire corporate sector. The guidelines should clearly define situations wherein tax treaty benefits can be denied. Where 'limitation of benefits (LOB)' conditions prescribed in a tax treaty are fulfilled, GAAR provisions should not be invoked to deny tax treaty benefits. LOB provisions prevent treaty abuse by ensuring that a company resident in Country X does not obtain tax treaty benefits under the treaty between India and Country Y, by setting an intermediate company in Country Y. If the intermediate company satisfies certain parameters based on activity, expenditure etc then treaty benefits are not denied

11. Reference Books, Sites and Cases

1. OECD, Glossary of tax terms
2. Concise Oxford Dictionary (Tenth Edition)
3. Vienna Convention on the Law of Treaties, 1969
4. 2010 Commentary to Article 1 of the OECD Model
5. Convention
6. Direct Tax Code
7. Income Tax Act, 1961
8. Board Circulars

Websites referred to:

.1 http://www.cra-arc.gc.ca/E/pub/tp/ic88-2s1/README.html

.2 http://www.canadiantaxlitigation.com/?gclid=CK2btan-07ECFUXc4AodbRAhfg

.3 http://www.cga-canada.org/en-ca/AboutCGACanada/CGAMagazine/2006/Mar-Apr/Pages/ca_2006_03-04_ft1.aspx

http://www.cra-arc.gc.ca/ebci/cjcm/srch/bscSrch?bscSrch=Gaar 〈=en

.4 http://www.financialpost.com/m/wp/legal-post/blog.html?b=business.financialpost.com/2011/12/16/supreme-

court-of-canada-upholds-use-of-general-anti-avoidance-rule-against-li-familys-copthorne-holdings-unit

.5 http://taxdisputehelp.ca/2012/01/supreme-court-of-canada-releases-gaar-decision/

.6 http://www.google.ca/search?q=canada+revenue+agency&ie=UTF-8&oe=UTF-8&hl=en&client=safari

.7 www.worldfinance.com/.../uncertainty-surrounds-indias-gaar-implem

.8 The Essential GAAR Manual: Policies, Principles and Procedures By William I. Innes, Patrick J. Boyle, Fraser Milner Casgrain (Firm), Joel A. Nitikman

ANNEXURE 1

REFERENCE SECTIONS 95-102

*95.

Applicability of General Anti-Avoidance Rule.-Notwithstanding anything ontained in the Act, an arrangement entered into by an assessee may be eclared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined subject to the provisions f this Chapter.

Explanation. — For the removal of doubts, it is hereby declared that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

*96.

Impermissible avoidance arrangement.-(1) An impermissible avoidance arrangement means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and it—

(a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length ;

(b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act ;

(c) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part ; or

(d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.

(2) An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

*97.

Arrangement to lack commercial substance.-(1) An arrangement shall be deemed to lack commercial substance if—

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part ; or

(b) it involves or includes—

(i) round trip financing ;

(ii) an accommodating party ;

(iii) elements that have effect of offsetting or cancelling each other ; or

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction ; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(2) For the purposes of sub-section (1), round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement ; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter), without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement ;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received ; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

(3) For the purposes of this Chapter, a party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

(4) The following shall not be taken into account while determining whether an arrangement lacks commercial substance or not, namely :—

(i) the period or time for which the arrangement (including operations therein) exists ;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement ;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

*98.

Consequence of impermissible avoidance arrangement.-(1) If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences, in relation to tax, of the arrangement, including denial of tax benefit or a benefit under a tax treaty, shall be determined, in such manner as is deemed appropriate, in the circumstances of the case, including by way of but not limited to the following, namely :—

(a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement ;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out ;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person ;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount ;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital or revenue nature ; or

(ii) any expenditure, deduction, relief or rebate ;

(f) treating—

(i) the place of residence of any party to the arrangement ; or

(ii) the situs of an asset or of a transaction,

at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement ; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(2) For the purposes of sub-section (1),—

(i) any equity may be treated as debt or vice versa ;

(ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa ; or

(iii) any expenditure, deduction, relief or rebate may be recharacterised.

*99.

Treatment of connected person and accommodating party.-For the purposes of this Chapter, in determining whether a tax benefit exists—

(i) the parties who are connected persons in relation to each other may be treated as one and the same person ;

(ii) any accommodating party may be disregarded ;

(iii) such accommodating party and any other party may be treated as one and the same person ;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

*100.

Application of Chapter.-The provisions of this Chapter shall apply in addition to, or in lieu of, any other basis for determination of tax liability.

*101. Framing of guidelines.-The provisions of this Chapter shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed.

*102. Definitions.-In this Chapter, unless the context otherwise requires,—

1) "arrangement" means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding ;
2) "asset" includes property, or right, of any kind ;
3) "associated person", in relation to a person, means—
   a) any relative of the person, if the person is an individual ;

b) any director of the company or any relative of such director, if the person is a company ;
c) any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member if the person is a firm or association of persons or body of individuals ;
d) any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family ;
e) any individual who has a substantial interest in the business of the person or any relative of such individual ;
f) a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member ;
g) a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member have a substantial interest in the business of the person, or family or any relative of such director, partner or member ;
h) any other person who carries on a business, if—
    I. the person being an individual, or any relative of such person, has a substantial interest in the business of that other person ; or
    II. the person being a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person ;

4) "benefit" includes a payment of any kind whether in tangible or intangible form ;
5) "connected person" means any person who is connected directly or indirectly to another person and includes associated person ;

6) "fund" includes—
   a. any cash ;
   b. cash equivalents ; and
   c. any right, or obligation, to receive, or pay, the cash or cash equivalent ;
7) "party" means any person including a permanent establishment which participates or takes part in an arrangement ;
8) "relative" shall have the meaning assigned to it in the Explanation to clause (vi) of sub-section (2) of section 56 ;
9) a person shall be deemed to have a substantial interest in the business, if—
   a. in a case where the business is carried on by a company, such person is, at any time during the financial year, the beneficial owner of equity shares carrying twenty per cent. or more, of the voting power ; or
   b. in any other case, such person is, at any time during the financial year, beneficially entitled to twenty per cent. or more, of the profits of such business ;
10) "step" includes a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement ;
11) "tax benefit" means—
   i. a reduction or avoidance or deferral of tax or other amount payable under this Act ; or
   ii. an increase in a refund of tax or other amount under this Act ; or
   iii. 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
   iv. an increase in a refund of tax or other amount under this Act as a result of a tax treaty ; or
   v. a reduction in total income including increase in loss,

   in the relevant previous year or any other previous year.

12) "tax treaty" means an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A.

* Inserted by FA 2012, wef. 1-4-2014.

ANNEXURE 2

Following Draft Guidelines regarding implementation of General Anti Avoidance Rules (GAAR) in terms of Section 101 of the Income Tax Act, 1961 were issued today by the Central Board of Direct Taxes (CBDT).

Background

The Chairman, CBDT, Vide OM F.NO. 500/111/2009-FTD-1 Dated 27 February, 2012 constituted a Committee under the Chairmanship of the Director General of the Income Tax (International Taxation) to give recommendations for formulating the guidelines for proper implementation of GAAR Provisions under the Direct Tax Code Bill, 2010 and to suggest safeguards to these provisions to curb the abuse thereof. The Committee comprised of the following officers :-

1. Director General of Income Tax (International Taxation)- Chairperson

2. Joint Secretary (FT& TR-I)

3. Joint Secretary (FT& TR-II)

4. Joint Secretary (TPL-I)

5. Director of International Taxation, Ahmedabad

6. Director, FT & TR-III

7. Addl. Director on Income Tax, Range-I (IT), New Delhi, Member Secretary.

The terms of reference of the Committee was as under

:-

a) Recommendations for formulating guidelines to implement the provisions of General Anti-Avoidance Rules(GAAR) as per section 123 of the Direct Tax Code Bill, 2010; and

b) Draft a circular as a safeguard so that the GAAR provisions are not applied indiscriminately in every case.

The Committee met for the first time on 6th March, 2012 and felt that the existing provisions of the Direct Tax Code Bill 2010(DTC) needed certain modifications and therefore various specific suggestions were made in this regard. These included suggestions on defining various terms as appearing in the DTC, changing the procedure of invoking the provisions of GAAR, prescribing time limits etc.

Subsequent to the first meeting, the Finance Bill 2012 was presented before the Parliament and it was gathered that most of the suggestions given in the first meeting were addressed in the Finance Bill 2012. The Committee thereafter examined the provisions related to GAAR in the Finance Bill 2012 as modified through Government amendments during the passage of the Bill in Parliament. The recommendations regarding guidelines/circulars have been made in light of the final provisions relating to GAAR in the Finance Act, 2012.

The Committee held several meetings between 06.03.2012 to 28.05.2012.

After exhaustive deliberations and broad based discussions with the officers, representatives of FII‟s, members of the advisory committee and others stake holders, the Committee makes the following recommendations which would need to be split between Circulars and the Rules.

Proposals for inclusion in the guidelines

A) Guidelines u/s 101

Section 101 of the Finance Act, 2012, provides that "the provisions of this Chapter shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed". The Committee makes the following recommendations to be incorporated in the guidelines.

a) Monetary threshold

The committee feels that in order to avoid the indiscriminate application of the GAAR provisions and to provide relief to small taxpayers, there should be monetary threshold for invoking the GAAR provisions. In this regard, the following recommendation is made by the committee.

Only an arrangement or arrangements where the tax benefit through the arrangement(s) in a year to an assessee is above Rs. ___ lacs will be covered by GAAR provisions.

b) Prescription of statutory forms

The committee feels that consistency of approach is
essential in the procedures for invoking the GAAR provisions. It also feels that adequate safeguards should be provided to ensure that principles of natural justice were not violated and there is transparency in the procedures. Therefore, the committee is of the opinion that there should be prescribed statutory forms for the following:-

i) ***For the Assessing Officer to make a reference to the Commissioner u/s 144BA(1) (Annexure-A)***

ii) ***For the Commissioner to make a reference to the Approving Panel u/s 144BA(4) (Annexure-B)***

iii) ***For the Commissioner to return the reference to the Assessing Officer u/s 144BA(5) (Annexure-C)***

(The drafts thereof have been prepared and enclosed as above)

c) Prescribing the time limits

The committee feels that there should be absolute certainty about the time limits during which the various actions under the GAAR provisions are to be completed. Some of these time lines have been prescribed under the act under sections 144BA(1) and 144BA(13). For the remaining actions the following time lines are suggested by the committee :-

It may be prescribed that in terms of section 144BA(4), the CIT should make a reference to the Approving Panel within 60 days of the receipt of the objection

from the assessee and in case of the CIT accepting the assessee‟s objection and being satisfied that provision of chapter X-A are not applicable, the CIT shall communicate his decision to the AO within 60

days of the receipt of the assessee‟s objection as prescribed under section 144BA(4) r.w.s. 144BA(5). No action u/s 144BA(4) or (5) shall be taken by the Commissioner after the period of six months from the end of the month in which the reference under sub-section 144BA(1) was received by the Commissioner.

B) **Recommendations regarding setting up of the Approving Panel u/s 144(BA)**

Section 144BA(14) has empowered the CBDT to constitute Approving Panel consisting of not less than 3 members, out of which one member of the panel would be an officer of the level of Joint Secretary or above from the Ministry of Law and the others being the Income Tax Authorities of the rank of Commissioner and above. The committee deliberated on the constitution of this committee for efficient output and has made the following recommendations :-

(a) To begin with, there should be one Approving Panel, which shall be situated at Delhi. Subsequently, the CBDT should review the number of Approving Panels required on the basis of the workload in the FY 2014-15.

(b) The Approving Panel should comprise of three members, out of which, two members should be of the level of Chief Commissioners of Income Tax and the third member should be an officer of the level of Joint Secretary or

above from the Ministry of Law. All the members should be full time members.

(c) The Approving Panel should be provided the secretariat staff along with appropriate budgetary and infrastructure support by the CBDT. The secretariat should be headed by an officer of the level of Joint/Additional Commissioner of Income Tax.

C) **Recommendations for the Circular on GAAR**

a) Explaining the provisions of GAAR

For the purpose of explaining the provisions of GAAR and better understanding thereof, the Committee suggests a detailed note to be included in the circular, which is enclosed as **Annexure- D**.

b) Special provisions for Foreign Institutional Investors (FII's)

Foreign Institutional Investors have expressed certain concerns regarding GAAR provisions. The committee met the representatives of Asia Securities Industry & Finance Markets Association and Capital Markets Tax Committee of Asia. After discussions, the representatives of these bodies gave following suggestions to resolve their apprehensions.

1. To exempt Capital Market transactions entirely from the GAAR provisions

2. A flat tax on FII"s gains without any distinction between various transactions could be considered.

3. The tax authorities could attempt to clarify the details of each provision in the GAAR. For this, they gave comments on how the relevant provision may be clarified.

The committee considered the suggestions of the representatives. Option No. (1) & (2) above are not viable options as it is not permitted under the provisions of the Income Tax Act. However option (3) could be considered. For this purpose, safe harbour could be provided to the FII‟s subject to the payment of taxes as per domestic law. Accordingly, the committee recommends the following.

Where a Foreign Institutional Investor (FII) chooses not to take any benefit under an agreement entered into by India under section 90 or 90A of the Act and subjects itself to tax in accordance with the domestic law provisions, then, the provisions of Chapter X-A shall not apply to such FII or to the non-resident investors of the FII.

Where an FII chooses to take a treaty benefit, GAAR provisions may be invoked in the case of the FII, but would not in any case be invoked in the case of the non-resident investors of the FII.

c) Clarity regarding retrospective/prospective operations of the GAAR provisions

Certain apprehensions have been raised regarding the retrospective/prospective operation of the GAAR provisions. It may therefore be clarified that :-

The provisions of GAAR will apply to the income accruing or arising to the taxpayers on or after 01.04.2013.

d) Interplay between Specific Anti-Avoidance Rules (SAAR) and General Anti-Avoidance Rules (GAAR).

Concerns have been raised that there could be interplay between the SAAR and GAAR. The committee examined this issue and the recommendation of the committee is as below:-

While SAARs are promulgated to counter a specific abusive behavior, GAARs are used to support SAARs and to cover transactions that are not covered by SAARs. Under normal circumstances, where specific SAAR is applicable, GAAR will not be invoked. However, in an exceptional case of abusive behavior on the part of a taxpayer that might defeat a SAAR, as illustrated in Example No. 16 in Annexure E (or similar cases), GAAR could also be invoked.

e) Definition of "connected person"

Concerns have been raised that the definition of "connected person" u/s 102 (5) is too broad and ambiguous. The committee recommends that it may be clarified that:-

"Connected person" would include the definition of "associated enterprise" given in section 92A, the definition of „relative" in section 56 and the "persons" covered u/s 40A(2)(b).

f) Concern regarding application of section 96(2)

Concerns have been raised in various fora that section 96(2) provides that an arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of the arrangement is to obtain a tax benefit, notwithstanding the fact

that the main purpose of the whole arrangement is not to obtain a tax benefit. In view of this provision where only a part of the arrangement is to obtain a tax benefit, the tax authorities will treat the whole arrangement as an impermissible arrangement.

In order to allay the apprehensions of the taxpayers in this regard, the committee recommends that it must be clarified in the Rules that :-

Where only a part of the arrangement is impermissible, the tax consequences of "Impermissible Avoidance Arrangement" will be limited to only that part of the arrangement.

g) Illustrative cases under GAAR

The committee felt that terms like, "Misuse or abuse", "bona fide purpose" and "lacks commercial substance" may be explained by illustrations. However it may be clarified that it should be only an indicative list and not an exhaustive list. The committee has recommended a few illustrative cases, which are given in **Annexure-E**. The guidelines provided through examples are based on specific facts in the particular example. Whether GAAR may be invoked in any particular case would depend on the specific facts of that case.

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Annexure-A

FORM FOR MAKING THE REFERENCE TO THE COMMISSIONER BY THE ASSESSING OFFICER FOR INITIATING THE PROCEEDINGS U/S 144BA(1) rws 95 OF THE INCOME TAX ACT, 1961

1	Name and Address of the Assessee
2	PAN
3	Status
4	Particulars of Assessing Officer
5	Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked : (a) Assessment Years pending in scrutiny (b) Other assessment years proposed to be covered

6	Provide a factual matrix of the "arrangement" entered into by the assessee
7	Is there any "Tax Benefit" as defined in section 102(11) ?
8	If yes, provide the approximate quantum thereof assessment year wise.
9	Is "Tax Benefit" the "main purpose" or one of the "main purposes" of the "arrangement" ?
10	Brief facts of the "Tax Benefit"
11	Has the assessee been confronted with the details of the "Tax Benefit"? If yes, provide the gist of the reply furnished by the assessee on "Tax Benefit"
12	If "Tax Benefit" is the "main purpose" or one of the "main purposes" specify

which other condition, out of the following is satisfied giving details how the conclusion has been arrived at:

(a) Creates rights, or obligations, which are not ordinarily

ANNEXURE 3

Copthorne case Facts

1992

Transaction 1- VHHC Investments sold VHHC Holdings to Copthorne Holding Ltd. , a group company for nominal price

Transaction 2- VHHC Holdings sold VHSUB shares to Copthorne Holding Ltd. Who further sold it to unrelated purchaser at FMV and realized capital loss and further set off the same against gain from sale of hotel sale transaction.

1993

Transaction 3- Copthorne sold VHHC Holding shares to Big City (Holding Company in Netherlands) to avoid elimination of $67,401, 279 at a nominal price

1994

Transaction4. – Horizontal Amalgamation of Copthorne Holdings Ltd., VHHC Holdings (subsidiary of Copthorne Holdings) and two other corporations.

Transaction 5- Pots amalgamation the new company (Copthorne II) was owned by Big City (Parent Company). PUC of Copthorne II shares owned by Big City were thus essentially the PUC of the shares of VHHC Holdings as the PUC of the shares of other corporations was nominal.

Transaction 6- A Barbados formed entity, LF Investments acquired shares of Copthorne II and VHHC Investments from Big City. No capital gains were payable by Big City on account of Netherlands Canada Tax Treaty.

1995

Transaction 7-Copthorne II, VHHC Investments and two other corporations got merged to form Copthorne III.

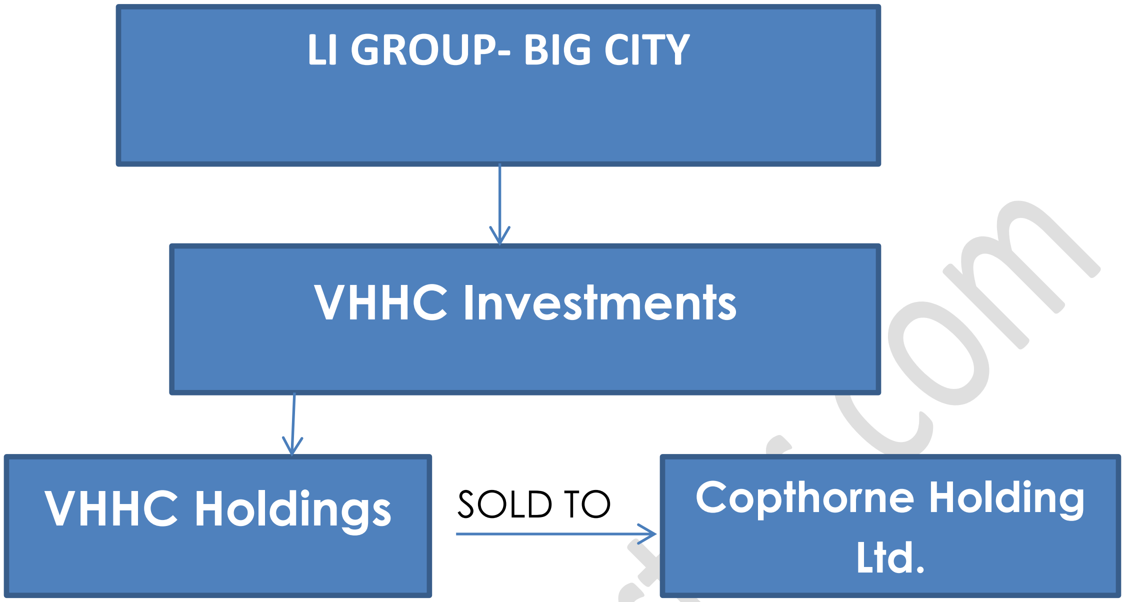
LF Investments received 164,138,025 shares @ 1$ per share in Copthorne III which was in effect sum total of PUC of VHHC Investments and VHHC Holdings

Transaction 8- Immediately after amalgamation Copthorne III redeemed 142,035,895 shares for $ 142.035,895 without payment of any deemed dividend tax or withholding tax as the redeemed value matched with PUC value.

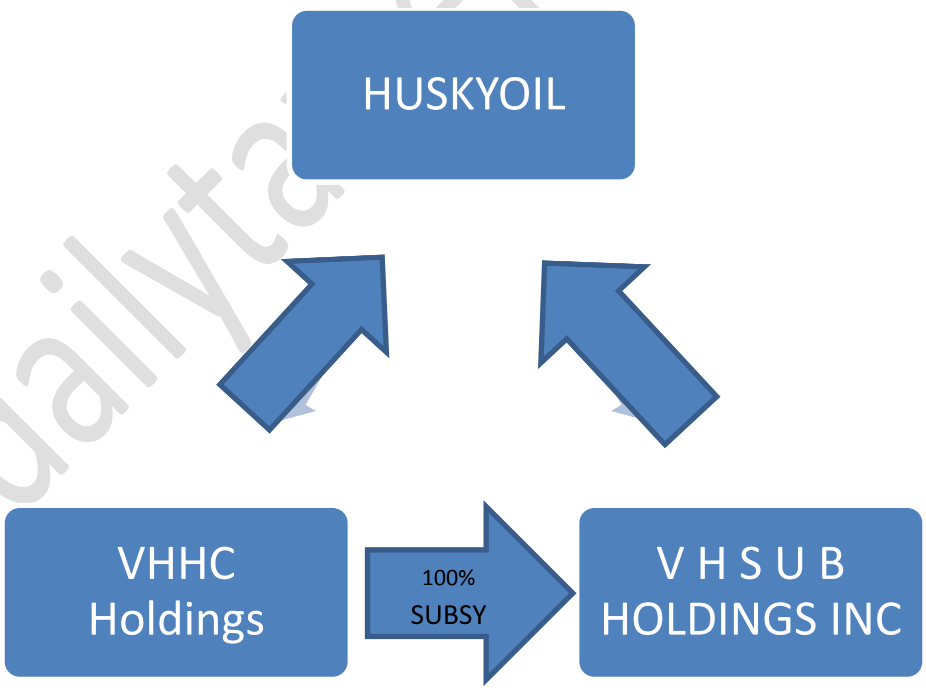
The revenues contention was that actually the real PUC was the PUC of the shares of VHHC investments being $ 96,736,845 since the 1991 transaction of transfer of VHHC holdings were actually was an abuse of the provisions of company law requiring cancellation of shares in vertical form of amalgamation.

FLOW CHART FOLLOWS:

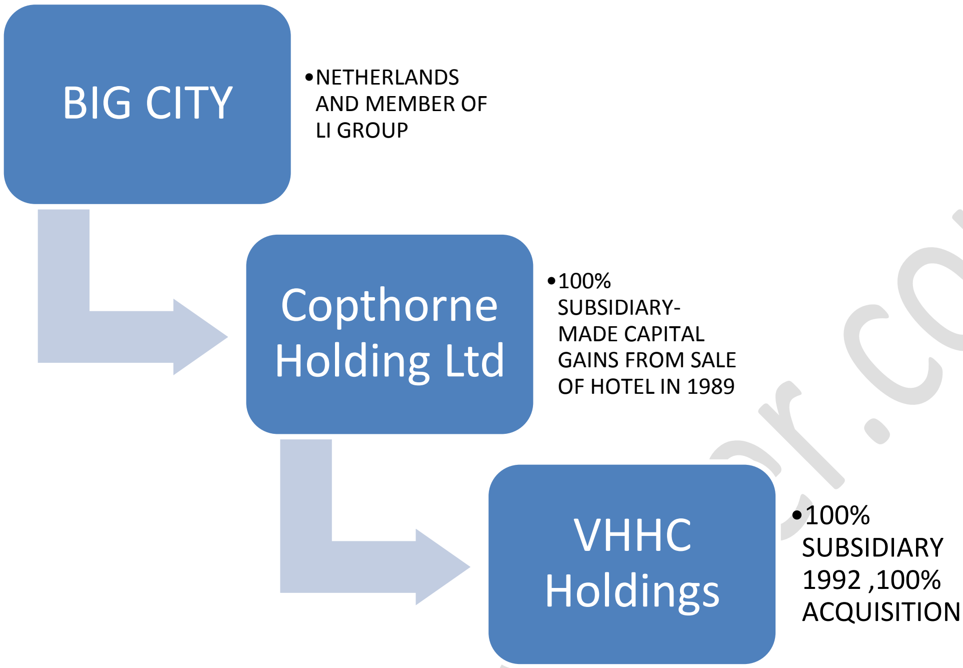
1991 POSITION



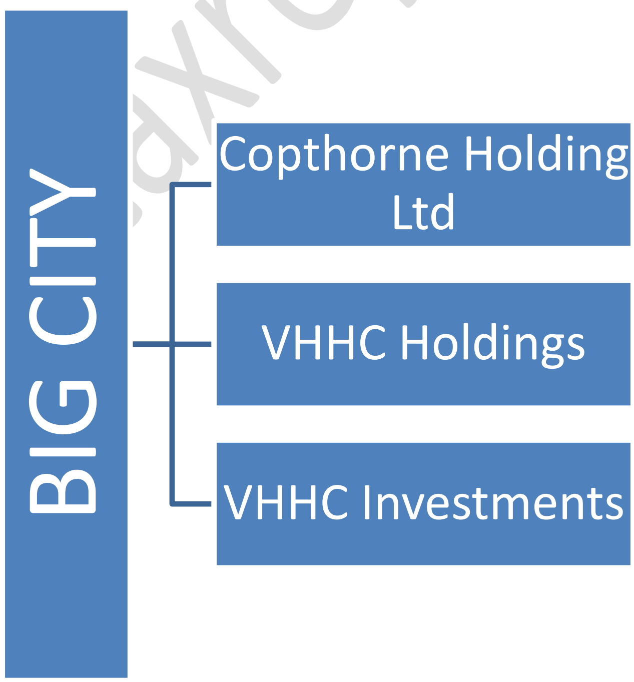
1991 POSITION



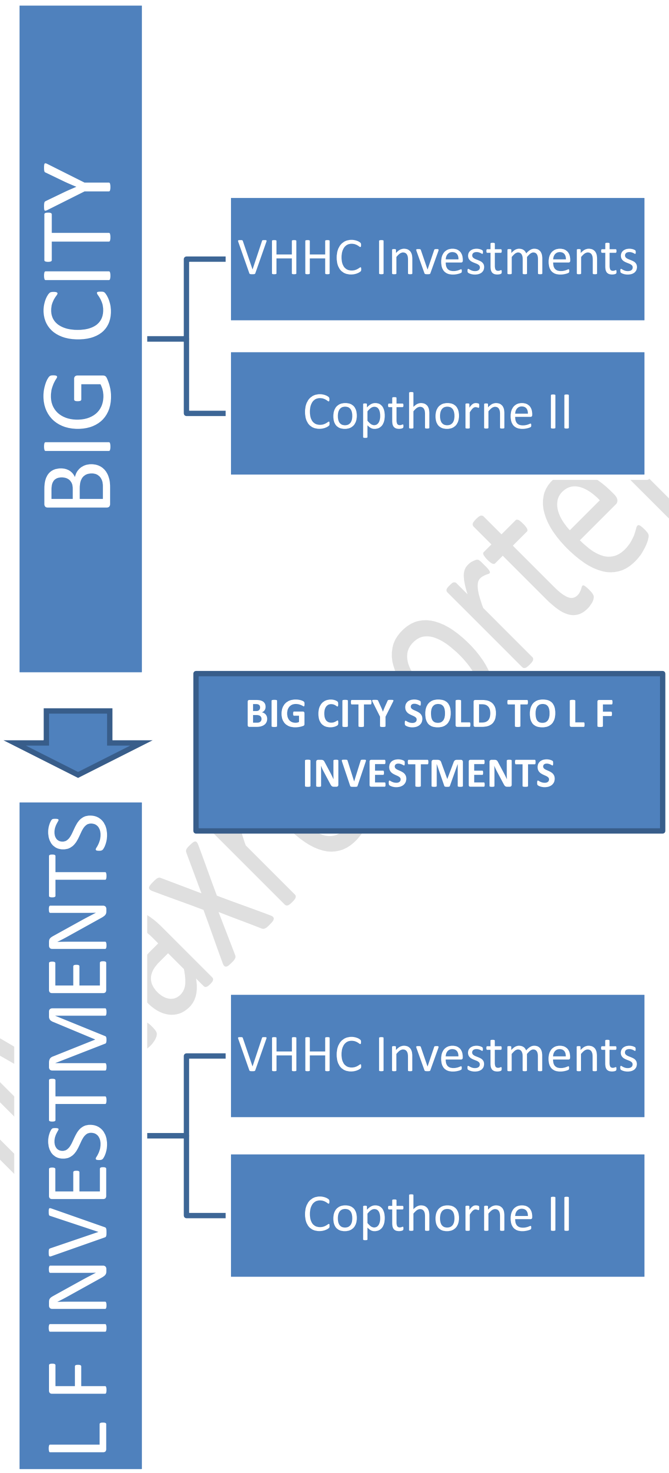
POSITION 1992 (VERTICAL)



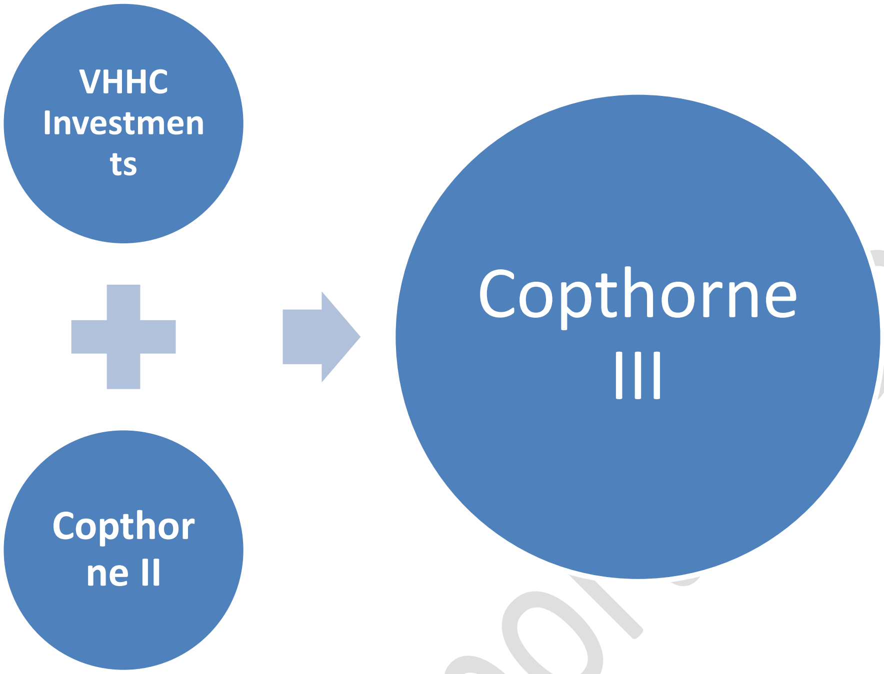
1993 POSITION (HORIZONTAL)



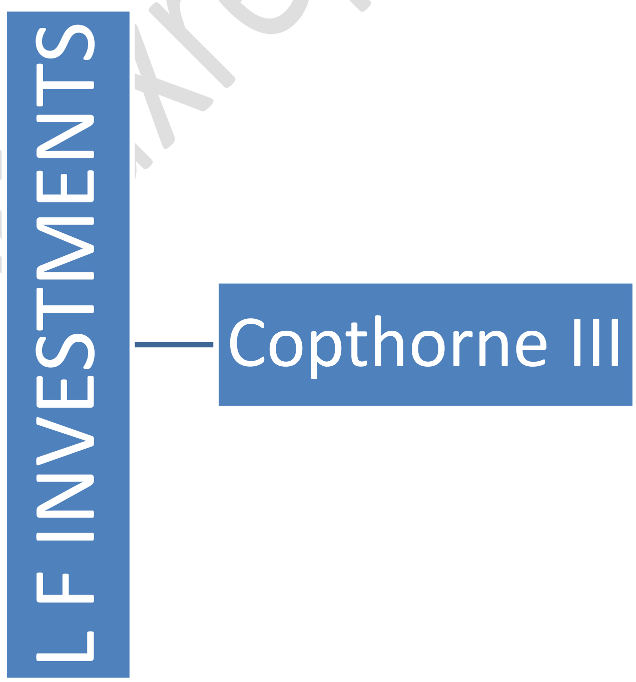
POSITION 1994 (VHHC HOLDINGS MERGED WITH COPTHORNE HOLDING LTD TO BECOME COPTHORNE II)



1995 POSITION



FINALLY TO BECOME



ANNEXURE 4

Information/Guidance Circular on GAAR under Canadian law with Examples of avoidance transactions/misuse and abuse of provisions of law

Revenue Canada
Taxation

INFORMATION CIRCULAR

NUMBER: 88-2

DATE: October 21, 1988

SUBJECT: GENERAL ANTI-AVOIDANCE RULE SECTION 245 OF THE INCOME TAX ACT

1. The purpose of this circular is to provide guidance with respect to the application of the general anti-avoidance rule, section 245 of the Income Tax Act (the Act). This rule applies with respect to transactions entered into after Royal Assent is given to Bill C-139 except for:
(a) transactions that are part of a series of transactions, commencing before the day of Royal Assent and completed before 1989 (and for this purpose a series of transactions does not include any related transactions or events completed in contemplation of the series), or

(b) any one or more transactions, one of which was entered into before April 13, 1988, that were entered into by a taxpayer in the course of an arrangement and in respect of which the taxpayer received from the Department of National Revenue, before April 13, 1988 a confirmation or opinion in writing with respect to the tax consequences thereof.

2. Revenue Canada, Taxation will issue advance rulings with respect to the

application of the general anti-avoidance rule to
proposed transactions and will publish summaries of the facts and rulings in those cases that will provide further guidance where the rulings themselves are not published.

In order to ensure that the rule is applied in a consistent manner, proposed assessments involving the rule will be reviewed by Revenue Canada, Taxation Head Office.

3. Subsection 245(2) states that where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that would result from that transaction or from a series of transactions that includes that transaction.

An avoidance transaction is defined in subsection 245(3) as a single transaction or one that is a part of a series of transactions where the Single transaction or the series results directly or indirectly in a tax benefit, unless the transaction is carried out primarily for bona fide purposes other than to obtain the tax benefit.

"Tax benefit" is defined to mean a reduction, avoidance or deferral of tax orother amount payable or an increase in a refund of tax or other amount under the Act.

Subsection 245(4) provides that the rule in subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole.

Avoidance transaction

4. An avoidance transaction is a single transaction carried out primarily to obtain a tax benefit. Where a transaction, which is primarily tax-motivated, forms part of a series of transactions that is carried out primarily for non-tax purposes, the single transaction will nevertheless be an avoidance transaction. The fact that the series of transactions has bona fide non-tax purposes does not preclude a tax-motivated transaction that forms part of the series from being an avoidance transaction.

An avoidance transaction does not include a transaction that "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit". The purposes of a transaction are determined not only from the taxpayer's statement of intention but also from all the circumstances of the transaction or transactions. If it can be inferred from all the circumstances that the primary or principal purpose in undertaking the transaction is other than to obtain a tax benefit, then the transaction is not an avoidance transaction.

A transaction will not be an avoidance transaction if the taxpayer establishes that it is undertaken primarily for a bona fide business, investment or family purpose. In making this determination it is important to distinguish those transactions which may have a business, investment or family effect from those which have a business, investment or family purpose.

There are many transactions that have a business, investment or family effect, which may nevertheless be avoidance transactions because the primary purpose of the transaction is to obtain a tax benefit. (See, for example, paragraph 22 where the partnership has a business effect but the primary purpose of the partnership is to obtain a tax benefit.)

Misuse or abuse

5. Subsection 245(4) states that the rule does not apply to an avoidance transaction if it may reasonably be considered that the transaction would not result in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole.

Transactions that rely on specific provisions, whether incentive provisions or otherwise, for their tax consequences, or on general rules of the Act can be negated if these consequences are so inconsistent with the general scheme of the Act that they cannot have been within the contemplation of Parliament.
On the other hand, a transaction that is consistent with the object and spirit of provisions of the Act is not to be affected. Revenue Canada will follow this principle in interpreting section 245 of the Act.

EXAMPLES

6. The examples that follow illustrate the approach that Revenue Canada will take in certain situations. The transaction or transactions described are assumed to comply with the relevant provisions of the Act and not to besubject to any other anti-avoidance rule. They are also assumed for the purposes of this circular to have been undertaken primarily to obtain a tax benefit and they are, for that reason, avoidance transactions. Therefore, the issue to be determined is whether they would be regarded as a misuse of a provision of the Act or an abuse having regard to the Act as a whole. The examples are general in nature, and, for this reason, care should be exercised in extending the interpretative comments to specific situations.

7. Divisive Reorganizations (Butterflies)

Facts
At the commencement of a series of transactions that will be carried out to divide the assets of a particular corporation pursuant to paragraph 55(3)(b), 50% of the shares of the particular corporation are owned by A and 50% are owned by B, an individual with whom A deals at arm's length. The corporation carries on two businesses. The shares of the particular corporation owned by B are transferred to Bco, B's wholly-owned corporation. Bco incorporates a subsidiary, Subco, the particular corporation transfers all the property of one business to Subco, and the particular corporation and the Subco elect under

subsection 85(1) in respect of the properties
transferred to defer the recognition of the gain that would otherwise be realized on the transfer.

Subco assumes liabilities of the particular corporation and issues to the articular corporation retractable preferred shares having a paid-up capital equal to the elected amount and a redemption amount equal to the amount by which the fair market value of the property transferred exceeds the non-share consideration. Subco redeems the preferred shares. The particular corporation purchases the common shares owned by Bco and Subco winds up into Bco. At the conclusion of the series of transactions Bco has received assets of the particular corporation in exchange for its shares of the particular corporation.

Interpretation

If each transaction in the series of transactions is consistent with the object and spirit of paragraph 55(3)(b), then subsection 245(2) would not apply. On the other hand if a transaction in the series of transactions results in a distribution of property that fails to comply with the object and spirit of paragraph 55(3)(b), then the particular corporation and Bco would be taxed in accordance with the provisions of subsection 55(2). This
might occur, for example, if a transferee does not receive its proportionate share of each type of property of the particular corporation. However, subsection 245(2) would be applied to a transaction that is part of a series of transactions that has been structured to avoid the effects of the application of subsection 55(2). 8. Consolidation of Profits and Losses in a Corporate Group

Facts

A corporation transfers property used in its business to a related corporation to permit the deduction of non-capital losses of the related corporation. All of the shares of the two corporations have been owned by the same taxpayer during the period in which the losses were incurred.

Interpretation

The absence in the Act of restrictions against transferring property between

related corporations, the existence of specific
provisions permitting the payment of income and the transfer of losses between related corporations and references in the Explanatory Notes Relating to Income Tax Reform indicate that a transfer of the type in question is consistent with the scheme of the Act and, therefore, subsection 245(2) would not be applied.

However, if a transfer of a property or other transaction is undertaken to avoid a specific rule, such as a rule designed to preclude the deduction of losses after the acquisition of control of a corporation by an arm's length person, such a transfer would be a misuse of the provisions of the Act and be subject to section 245.

9. Facts
A person has property with an unrealized capital gain that it wishes to sell to a third party. A related corporation has a net capital loss. Instead of selling the property directly to the third party and realizing a capital gain, the person transfers the property to the related corporation and elects under subsection 85(1) to defer the recognition of the gain. The related corporation sells the property to the third party and reduces the resulting taxable capital gain by the amount of its net capital loss.

Interpretation
Subsection 69(11) does not permit a person to transfer property to an unrelated corporation on a tax-deferred basis where it is intended that the unrelated corporation will sell the property and reduce the amount of the gain by amounts of losses or similar deductions which it may claim. By implication, the subsection does permit a transfer to a related corporation on a tax-deferred basis. In these circumstances such a transfer would be acceptable as it is within the object and spirit of the Act.

10. Estate Freezes

Facts

Under a typical estate freeze arrangement a parent transfers to a newly-formed corporation all of the shares of an operating company and elects under subsection 85(1) in order to defer recognition of the gain on the transfer. The consideration for the transfer is preferred shares retractable at the option of the parent for an amount equal to the fair market value of the shares of the operating company transferred. The preference shares carry voting control. A trust for minor children of the parent subscribes for common shares of the new company for a nominal amount.

Interpretation

The Explanatory Notes state that estate freezes would not ordinarily result in misuse or abuse given the scheme of the Act including the recently enacted Subsection 74.4(4). Section 74.4 was enacted to deal with income splitting and could have application to certain estate freeze arrangements.

Subsection 74.4(2) may apply to deem an amount to be received as interest by an individual who loans or transfers property to the corporation and one of the main purposes of the loan or transfer may reasonably be considered to be to reduce the income of the individual and to benefit a designated person. A designated person is the individuals' spouse, or a person under 18 who does not deal with the individual at arm's length or who is the individual's niece or nephew.

Subsection 74.4(2) will not apply to "attribute" income to the individual throughout a period throughout which the corporation is a small business corporation as defined in subsection 248(1). In addition, as provided in subsection 74.4(4), the rule will not apply where the only interest which the designated person has in the corporation is a beneficial interest in the shares of the corporation which are held through a trust and the terms of the trust provide that the person may not obtain the use of any income or capital of the trust while the person is a designated person.

Subsection 245(2) will not apply to the transfer of the shares to the corporation where subsection 74.4(2) applies to deem the parent to receive an amount as interest. Similarly, subsection 245(2) would not apply where, for the reasons stated above, subsection 74.4(2) does not apply to deem the parent to receive an amount as interest.

Similar considerations would apply to other types of estate freezes involving a transfer of property by a parent to a corporation. For example, in an estate freeze carried out pursuant to section 86 of the Act, the parent would dispose of the shares of the operating company and receive preferred shares of the company having a redemption amount equal to the fair market value of the shares disposed of. The disposition of shares by the parent would constitute a transfer of property to the operating company for the purposes of subsection 74.4(2) of the Act and the application of subsection 245(2) to the transfer would be determined in the manner described above.

11. Incorporation of a Proprietorship

Facts

An individual taxpayer transfers his or her business to a corporation primarily to obtain the benefit of the small business deduction.

Interpretation

There is nothing in section 125 (that provides for the small business deduction) or elsewhere in the Act that prohibits an individual from incorporating his or her business. The incorporation is consistent with the Act read as a whole and, therefore, subsection 245(2) would not apply to the transfer of the business to the corporation.

12. Disposition of property

Facts

A taxpayer owns property that, if disposed of in a straightforward manner, would result in the immediate realization of income or a capital gain. The taxpayer and another taxpayer that wants to buy the property (the purchaser) form a partnership and the taxpayer transfers the property into the partnership and elects under subsection 97(2) to defer the recognition of gain which otherwise would arise. The purchaser contributes cash to the partnership in an amount equal to the fair market value of the property. The taxpayer withdraws all the cash from the partnership and, because of such withdrawal, the taxpayer's share of the income and loss of the partnership is reduced. The partnership continues to carry on business.

Interpretation

The use of the partnership is an attempt to circumvent the provisions that provide that proceeds of disposition of property are to be accounted for at the time of receipt and would be contrary to the scheme of the Act read as a whole. Subsection 245(2) would accordingly apply.

13. Facts

A corporation resident in Canada owns property, the proceeds of disposition of which would result in the immediate realization of income, a capital gain, or both. The taxpayer sells this property to an arm's length taxable Canadian corporation in consideration for redeemable shares having a redemption amount equal to the fair market value of the property sold. The taxpayer and purchaser elect under subsection 85(1) in respect of the property to defer recognition of the profit that would be realized on a straightforward sale of the property. The shares have paid-up capital equal to the amount elected so that on the redemption of the shares the taxpayer receives the profit on the sale as a taxable dividend deductible under subsection 112(1) of the Act.

Interpretation

If the property transferred is non-depreciable capital property, subsection 55(2) applies and the taxpayer would realize a capital gain equal to the difference between the redemption amount and the adjusted cost base of the redeemable preferred shares. Subsection 245(2) would, therefore, not apply.

On the other hand, if the property transferred is depreciable property or property the proceeds of disposition of which would result in the realization of income, subsection 245(2) would apply on the basis that the issue of the preferred shares is undertaken to avoid the consequences of a straightforward disposition of the property.

14. Part IV tax on Taxable Dividends Received

Facts

Each of two private corporations owns less than 10% of the common shares of a payer corporation that is to pay a substantial taxable dividend. The payer corporation will not be entitled to a dividend refund on the payment of the dividend. None of the corporations is related to any of the others. The private corporations form a corporation, Newco, transfer their shares of the payer corporation to Newco in exchange for common shares of Newco and elect under subsection 85(1) in respect to the transfer. Following the transfer of the payer corporation's shares to Newco, Newco will be connected with the payer corporation. The payer corporation pays the dividend to Newco, free of Part IV tax. Newco pays the same amount to the private corporations as a dividend, free of Part IV tax. The primary purpose for the transfer of the shares is to avoid the Part IV tax which would be payable if the dividend were received directly by the private corporations.

Interpretation

As the transfer of shares to the Newco is part of an arrangement undertaken to avoid the tax required by Part IV of the Act to be paid in respect of dividends received on portfolio shares, the transfer of the shares would be a misuse of a provision of the Act or an abuse of the Act as a whole and subsection 245(2) would be applied.

15. Capital gains exemption

Facts

The common shares of a corporation would be "qualified small business corporation shares" as defined in subsection 110.6(1) except that at the time in question all or substantially all of the assets of the corporation are not used in an active business carried on primarily in Canada. The shareholders wish to sell their shares and to have the gains qualify for the special increased capital gains exemption provided by subsection 110.6(2.1) of the Act. To achieve this result, the shareholders incorporate a corporation and transfer to this corporation shares of the operating corporation that have a
fair market value equal to the fair market value of the assets that are not used in the active business of the operating corporation. The operating corporation purchases these common shares from the new corporation and pays the purchase price of the shares by transferring the non-business assets to the new corporation. The operating corporation may have a tax liability arising from the disposition of the non-business assets. The new corporation may be subject to subsection 55(2) of the Act if the gain on the purchased shares is attributable to something other than income earned or realized by the operating corporation.

Interpretation

The formation of the new corporation and the transfer of the shares to the new corporation is not an abuse of the Act. The transfer of the non-business assets is governed by subsection 55(2) of the Act. Since the definition of a qualified small business corporation share does not require that all or substantially all of the assets be used in carrying on an active business in Canada for a particular period of time prior to the sale of the shares, the distribution of the non-business assets prior to the sale is acceptable. Therefore, in this case, the transactions undertaken to "purify" the corporation are in accordance with the scheme of the Act.

16. Services rendered to a Corporation

Facts

A corporation owes an amount for services rendered by a person who does not deal at arm's length with the corporation. The amount arises from a bona fide transaction and is deductible to the corporation. However the amount is not paid before the end of the second taxation year following the year in which the expense was incurred so as to maximize the deferral of its taxation in the hands of the person.

Interpretation

Section 78 (which deals with unpaid amounts) does not deny the deduction of a bona fide expense to a taxpayer in the year that it is incurred. It does, however, provide that either the taxpayer or the non-arm's length person will include the amount in income in the third taxation year following the year in which the expense is incurred. The deferral in such circumstances is contemplated by subsection 78(1) of the Act and subsection 245(2) would not apply.

17. Facts

An individual provides services to a corporation with which he or she does not deal at arm's length. The company does not pay a salary to the individual because payment of a salary would increase the amount of a loss that the company will incur in the year.

Interpretation

There is no provision in the Act requiring a salary to be paid in these or any circumstances and the failure to pay a salary is therefore not contrary to the scheme of the Act read as a whole. Subsection 245(2) would not apply to deem a salary to be paid by the corporation or received by the individual.

18. Facts

A Canadian-controlled private corporation pays its shareholder/manager an amount as salary that will reduce the corporation's income to its business limit for the taxation year. The amount of the salary is, however, not in excess of a reasonable amount.

Interpretation

Subsection 245(2) would not apply to the payment as the Act recognizes the deductibility of reasonable business expenses.

19. Deductibility of Interest Expense

Facts

A taxable Canadian corporation, which is profitable, has a wholly-owned taxable Canadian corporation that is sustaining losses and needs additional capital to carry on its business. The subsidiary could borrow the monies from its bank but the subsidiary could not obtain any tax saving in the current year by deducting the interest expense. Therefore, the parent corporation borrows the money from its bank and subscribes for additional common shares of the subsidiary and reduces its net income by deducting the interest expense. The subsidiary uses the money to gain or produce income from its business.

Interpretation

The borrowing by the parent corporation is for the purpose of gaining or producing income as required by paragraph 20(1)(c) of the Act and subsection 245(2) would, therefore, not apply.

20. Facts

A taxable Canadian corporation has agreed to purchase all of the shares of an operating corporation, which is also a taxable Canadian corporation. The purchaser incorporates a holding corporation which borrows the purchase price and pays the vendor for the shares. The holding corporation and the operating corporation amalgamate so that the interest payable on the monies borrowed to acquire the shares can be deducted in computing the income from the business of the amalgamated corporation.

Interpretation

The borrowing by the holding corporation and the amalgamation are not abusive and subsection 245(2) would not apply to the borrowing by the holding corporation.

21. Change of Fiscal Periods

Facts

An operating corporation merges with a shell corporation in an amalgamation described in subsection 87(1) of the Act. This merger is undertaken solely for the purpose of having the rules in paragraph 87(2)(a) deem the taxation year of the operating company to end immediately before the amalgamation, which year end will produce a tax benefit.

Interpretation

The definition of "fiscal period" in subsection 248(1) of the Act states that no change in the usual and accepted fiscal period may be made without the concurrence of the Minister. The use of the rules of subsection 87(2) to circumvent this requirement would be a misuse of subsection 87(1) and consequently subsection 245(2) would apply.

22. Transfer of Land Inventory

Facts

The taxpayer, a Canadian resident who holds land inventory that has appreciated in value wants to transfer the inventory on a rollover basis to a taxable Canadian corporation (the purchaser). Land inventory cannot be transferred on a tax-deferred basis under subsection 85(1). Since there is no prohibition in subsection 97(2) against transferring land inventory on a tax-deferred basis to a Canadian partnership, the taxpayer forms a partnership with the purchaser. The taxpayer transfers the land to the partnership and elects under subsection 97(2) to defer the gain on the transfer. The purchaser contributes a nominal amount of cash for its partnership interest. The vendor transfers the partnership interest to the purchaser in consideration for shares having a fair market value equal to the value of the partnership interest and the parties elect under subsection 85(1) in respect of the transfer. On the acquisition by the purchaser of the taxpayer's partnership interest the partnership ceases to exist and subsection 98(5) applies to deem the purchaser to acquire the land at the amount of the taxpayer's cost amount of the land.

Interpretation

The result of this series of transactions is that the taxpayer has avoided the recognition of the gain that the words of section 85 imply should be recognized in such circumstances. Although the partnership may carry on business and have a business effect, the formation of the partnership and the transfer of the land are undertaken to circumvent the prohibition in section 85. Subsection 245(2) would apply as the transfer of the land to the partnership is contrary to the scheme of the Act read as a whole taking into account the section 85 prohibition.

23. Debtor's Gain on Settlement of Debts (Section 80)

Facts

A person who has purchased the debt and shares of a company in financial difficulty (the taxpayer) intends to reorganize the capital of the taxpayer to convert debt into shares. The debt of the taxpayer has a cost to the person that is less than its principal amount. The fair market value of the assets of the taxpayer is less than its principal amount with the result that payment of the debt by the issuance of shares will result in the application of section 80. To avoid this result the taxpayer transfers all of its property to a wholly-owned subsidiary ensuring that the amounts elected under subsection 85(1) result in the recognition of income from which the losses of the taxpayer may be deducted. The person then forgives the debt. The taxpayer amalgamates with its wholly-owned subsidiary with the result that all of the property of the subsidiary (which was formerly property of the taxpayer) becomes property of the amalgamated company. Section 80 would apply on the forgiveness of debt but only to reduce the adjusted cost base of the shares of the subsidiary. Since these shares are cancelled on the amalgamation, the application of the section is of no effect.

Interpretation

In this situation the transfer of the assets of the taxpayer to the wholly-owned subsidiary that is undertaken solely to avoid the results of a straightforward forgiveness of the debt would be subject to subsection 245(2).

24. Reserves for an Amount not due until a Later Year

Facts

The owner of real property has agreed to sell the property to an arm's length purchaser. The purchaser wants to buy the property for cash, but the owner does not want to recognize the sale proceeds in the year of sale. The owner sells the real property to an intermediary company deferring receipt of the proceeds of disposition of the property for more than two years after the date of sale. The intermediary immediately sells the property to the third party for cash. The owner receives interest from the intermediary in respect of the monies received by the intermediary from the third party.

Interpretation

As the interposition of the intermediary is made solely to enable the owner of the property to defer recognition of the gain the sale of the real property to the intermediary would be subject to subsection 245(2).

25. Dividend Stripping (Subsection 247(1))

As a consequence of the introduction of section 245, subsection 247(1) is repealed. Subsection 247(1) is directed at a transaction or series of transactions one of the purposes of which is to effect a significant reduction of, or

disappearance of, assets of a corporation in order to
avoid the whole or part of the tax that would have been payable on the distribution of property of a corporation.

In 1986, Revenue Canada, Taxation confirmed that subsection 247(1) could apply to a transaction or series of transactions that were undertaken to circumvent specific provisions that provided that a shareholder who disposes of shares to the issuing corporation account for an amount received on the disposition as a dividend rather than as proceeds of disposition. The specific rules mentioned at that time were sections 84.1 and 212.1 and subsections 66.3(2), 85(2.1), 192(4.1) and 194(4.1). The latter two subsections have since been repealed and subsection 85.1(2.1) has been enacted to restrict the increase in paid-up capital on a share for share exchange.

Also, Part II.1 imposes a tax on certain corporations that pay an amount to a taxpayer as a substitute for normal dividends if they pay such amount in a manner that allows the recipient to account for the amount received as proceeds of disposition of property.

Provisions, such as those mentioned above, indicate the circumstances in which amounts received by a shareholder of a corporation from the corporation on a disposition of shares or other property are to be accounted for as a dividend. If as a result of a series of transactions a shareholder realizes a capital gain on the disposition of property and a transaction in the series is an avoidance transaction, subsection 245(2) will be applied to the
transaction if it is determined that the series of transactions was carried out to thwart the purpose of the provision in question.

26. Issue of stock dividend

Facts

A private corporation wishes to provide an annual dividend payment to its individual shareholders as tax-free capital gains. The corporation as part of an arrangement pays a stock dividend to its shareholders where the stock dividend shares received have a low paid-up capital and a high fair market value. As part of the same arrangement the shares are purchased by a corporation related to the issuing corporation or a third party broker or dealer where the purchase price of the shares is funded by the issuing corporation.

Interpretation

As the payment and repurchase of the stock dividend shares is part of an arrangement to avoid the shareholder tax required to be paid on dividends from the corporation, the payment and repurchase would be a misuse of a provision of the Act or an abuse of the Act as a whole and subsection 245(2) would apply.

Subsection 245(2) may also apply in other situations involving a reduction of assets of a corporation.

27. Conversion of Salary into Capital Gain

Facts

An employee of a private corporation wishes to receive a bonus, salary or a portion of the employer's profit as a capital gain in order to claim the capital gains exemption. The employee subscribes for preferred shares of the employer, which are redeemable at a premium that reflects a portion of the employees' annual salary or the employer's book profit. Prior to their redemption, the preferred shares are purchased by a company related to the employer corporation, thereby allowing the employee to receive a distribution of surplus as a capital gain.

Interpretation

The acquisition of the preferred shares is part of an arrangement designed to

avoid the tax that would have been required to be paid
on salary. The acquisition therefore results in an abuse of the Act as a whole and subsection 245(2) would apply.

28. Redemption of Preferred Shares following an Amalgamation

Facts
A taxable Canadian corporation merges with another taxable Canadian corporation that is a shell company. On the merger the shareholders who controlled the predecessor receive common shares of the merged company and the minority shareholders of the predecessor receive redeemable preferred shares that are immediately redeemed. The sole reason that the minority shareholders receive shares instead of cash is to cause the merger to comply with the requirements of paragraph 87(1)(c) of the Act.

Interpretation
Subsection 245(2) would not apply to the issue of the preferred shares as such issue is not regarded a misuse of a provision of the Act or an abuse of the Act read as a whole.