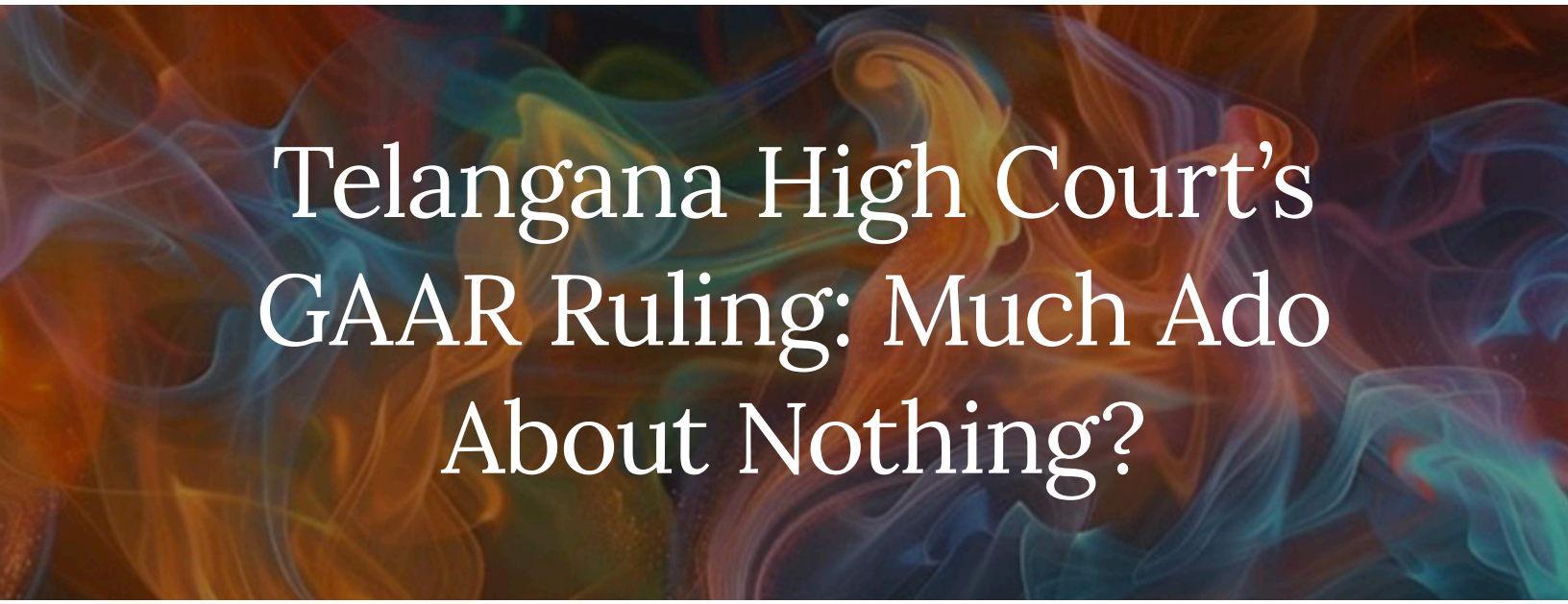
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Telangana High Court's GAAR Ruling: Much Ado About Nothing?

Key Takeaways

- The ruling amplifies the requirement of documenting and demonstrating commercial substance of transactions
- While the tax department may want to use the ruling to question all bonus share issuances, genuine transactions where the route is used as a tax planning tool can be executed
- The court hasn't necessarily held that GAAR can be applied where SAAR exists; rather it's permitted GAAR since SAAR wasn't applicable here

Introduction

Bad facts make bad law. That, in brief, sums up the recent Telangana High Court order upholding the tax department's decision to apply the General Anti-Avoidance Rules (**GAAR**) in a transaction involving bonus stripping.

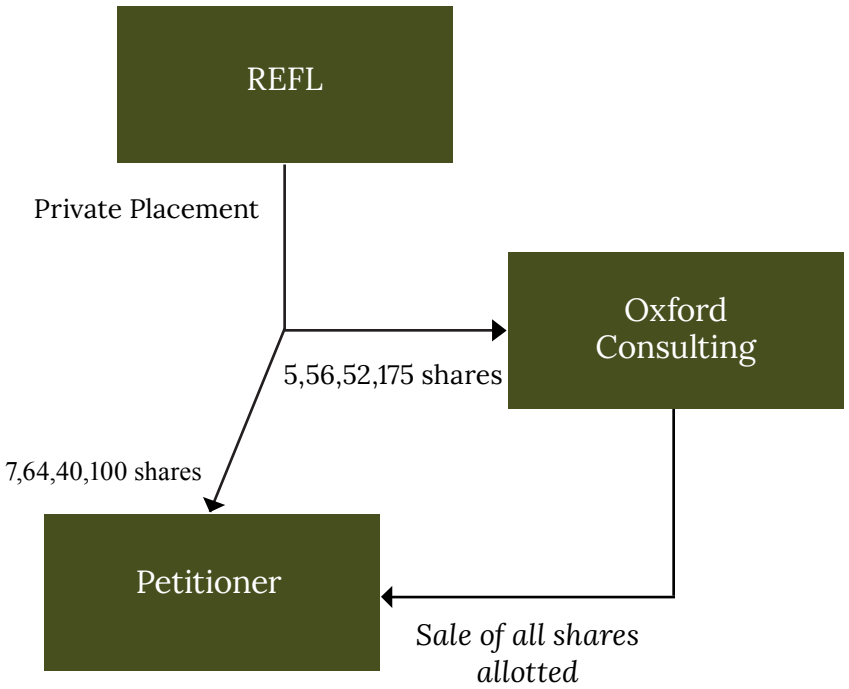
Typically used to reduce capital gains tax liability, the transaction involves buying shares in a company knowing that it'll soon issue bonus units/shares. Usually, the share value drops after the shares are received to reflect the ex-bonus value. Sale of regular shares previously acquired (prior to a bonus issue) at the reduced price would result in a capital loss, which can be set off against any capital gains.

The transactions, which were contested before the High Court, also sought to use this bonus stripping provision under the Income Tax Act, 1961 (**Act**). It involved:

- Ramky Estate and Farms Ltd. (**REFL**) issued shares to Alla Ayodhya Rami Reddy (**Petitioner**) and Oxford Ayyapa Consulting Services Pvt. Ltd. (**Oxford Consulting**) on a private placement basis.

- Shortly after that, REFL issued bonus shares to its shareholders. Consequently, the face value of each share reduced to 1/6th of its value.

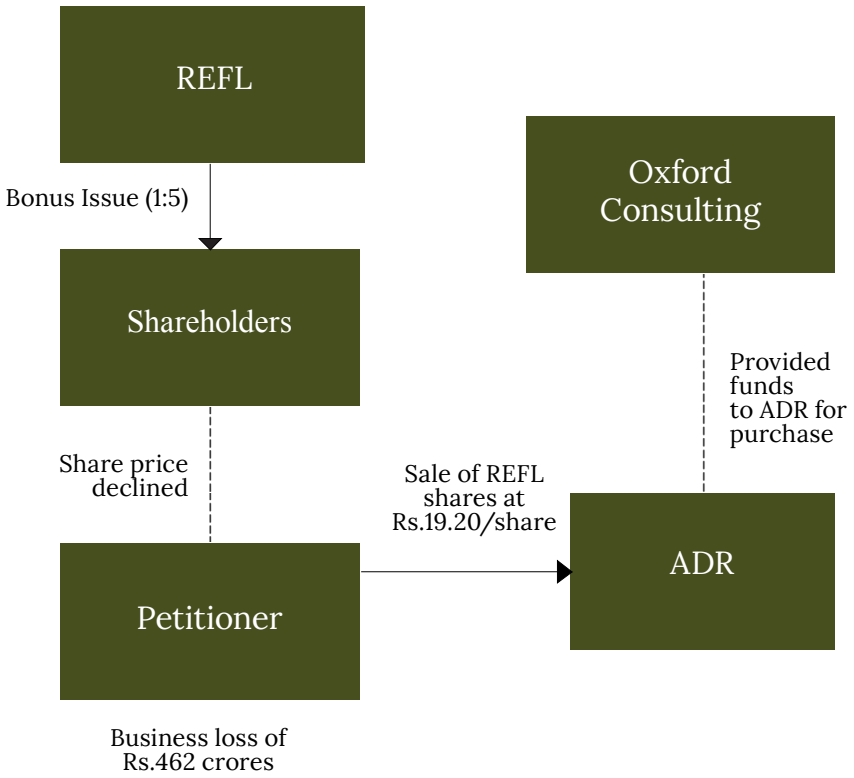
- The Petitioner sold his shares in REFL to Advisory Services Pvt. Ltd. (**ADR**) resulting in a short-term capital loss of Rs 462 crores. The Petitioner then sought to set it off against long terms capital gains from another transaction of sale of shares.



- REFL alloted 7,64,40,100 shares on a private placement basis to the Petitioner and 5,56,52,175 shares to Oxford Consulting

- Immediately thereafter, the Petitioner purchased Oxford's shares in REFL.

Phase 2



- REFL declared bonus shares in the ratio of 1:5. Post which, the value of the shares declined from Rs. 115 per share to Rs. 19.20 per share.
- The Petitioner sold shares purchased from Oxford Consulting to its group company ADR at the rate of Rs. 19.20 per share, thereby, resulting in a capital loss of Rs. 462 crores
- To purchase these shares, ADR received the funds from Oxford Consulting.

Reddy's Arguments

The Petitioner argued that bonus stripping transactions are subject to Specific Anti-Avoidance Rules (**SAAR**) by way of Section 94(8) of the Act. The provision permits the tax department to ignore the loss arising from sale/purchase of mutual fund units[1] for calculating taxable income.

Reddy argued that the Parliament never had the intention of including shares and securities within the scope of bonus stripping. Any bonus stripping that takes place in a share sale transaction is excluded from SAAR. And what's specifically excluded from SAAR cannot be indirectly curbed by applying GAAR.

The Petitioner also pointed to the Shome Committee Report which had recommended that where SAAR is applicable to a particular transaction, GAAR shouldn't be invoked. The Committee was set up by the Central Government to finalise GAAR guidelines.

[1] The Finance Act, 2022 amended section 94(8) to include bonus stripping via securities transactions as well. Until then, the provision only applied to mutual fund units.

High Court's View

Accepting the tax department's arguments, the High Court noted that:

- *GAAR provisions were enacted when the SAAR provision, i.e. Section 94(8) already existed. The GAAR provisions have a non-obstante clause, meaning they have an overriding effect on provisions that existed prior to them.*

- *Section 94(8) can be applied to bonus share issuances where there is an underlying commercial substance. In this case, the issuance is an artificial avoidance agreement that lacks any practical or logical justification.*

- *Shome Committe's recommendations were only partially incorporated in the law. Even so, the specific suggestion of SAAR prevailing over GAAR was in the context of international agreements, not domestic cases such as this.*

- *The burden of proof to disprove the presumption of tax as per GAAR provisions is on the taxpayer. In this case, there is clear and convincing evidence to suggest that the entire arrangement was intricately designed with the sole intent of evading tax, and the Petitioner hasn't proved otherwise.*

Implications

To begin with, it is unclear why the Petitioner took the writ route, as this forum is typically reserved for matters involving manifest jurisdictional errors or abuse of power, neither of which seem applicable here, says ***Anand Laxmeshwar, Partner at Bobby Parikh Associates***. Compounding matters further, the High Court, instead of simply dismissing the writ (given the absence of qualifying factors for its invocation) has thoroughly examined its merits. Because of these seemingly uncalled-for overtures from both sides, we now have a scenario where the High Court has effectively pre-judged the case to say that there was tax avoidance, without requiring the revenue department to have first established it through the elaborate procedures prescribed for GAAR-related matters, Laxmeshwar points out.

It does appear that the court was a bit premature in holding that the transaction was 'designed to side-step tax obligations' at the notice stage, that is, while the prescribed process was still underway, concurs ***Ruchir Sinha, Managing Partner at Resolüt Partners***.

Choice of forum aside, the Petitioner in this case should've made some effort to say while we're arguing about the legal point of SAAR overriding GAAR, here are the business reasons for why we did the transaction in the first place, says ***Abhishek Goenka, Partner at Aeka Advisors***.

> *The court hasn't really held that GAAR can be applied in instances where SAAR is applicable. Instead, he says, the bench concluded that SAAR wasn't applicable in this case, and so the general rules will apply. If there is a specific provision laying out the consequences of a transaction, you cannot further unravel it under GAAR*
>
> *- **Abhishek Goenka***
> *Partner, Aeka Advisors*

Since the Petitioner in this case didn't offer a business rationale, the fear is that the revenue department may start using this ruling to go after genuine bonus issue transactions even if they do not satisfy the anti-abuse conditions of Section 94. This is why it's advised to document the commercial reasons for such issuances, ***Goenka*** says.

For instance, one of the genuine uses of the bonus stripping provision is by IPO-bound companies who issue bonus shares to reduce the per share price. As startups raise money, they have a smaller number of shares. So, the per share price ends up being quite high and as they come closer to an IPO, they want to bring down the price for retail investor participation. In such cases, there is a very strong rationale for issuing bonus shares, and investors could end up selling after the bonus issuance. Thereby, the investors could end up making a gain on bonus shares and a loss on original shares and use the set-off provision for the loss.

Ketan Dalal, Managing Director at Katalyst Advisors also holds the view that the High Court was faced with a set of facts which possibly led it to conclude the way it did.

> *But if there is a SAAR provision enacted after GAAR, and for some reason, the SAAR provision does not apply, then GAAR should not be invoked*
>
> *- **Ketan Dalal***
> *Managing Director, Katalyst Advisor*

He illustrated this with an example: "Chapter XA regarding GAAR was introduced with effect from AY 2016-2017. The thin capitalisation provision under Section 94B (which is a SAAR provision) was introduced with effect from AY 2018-2019. The SAAR provision talks of an Indian borrower being restricted from claiming interest as a deduction, if interest to an associated party is more than 30% of EBITDA. Assume that the interest is less than 30% of EBITDA – say 28%. In this example, GAAR should not apply based on some general proposition that it is still quite excessive. The fact that the SAAR provision does not apply should be enough defence that GAAR does not apply as an alternative thereto. It also seems that this should be the position regardless of whether SAAR was introduced after GAAR or before GAAR."

The entire foundation of the case, adds ***Sinha***, seems to depend on the argument that GAAR will not apply where SAAR is applicable.

> *This line of argument only has good persuasive value since the Income Tax Act didn't incorporate all recommendations of the Shome Committee. In fact, the law is clear to allow GAAR to override situations even where SAAR applies, though it is unlikely that department would apply GAAR in such cases, unless the structure is bereft of genuine business purpose. Besides, SAAR wasn't even applicable to 'shares' but merely to units at that point in time.*
>
> **– Ruchir Sinha**
> *Managing Partner, Resolüt Partners*

Commercially speaking, it's unlikely that this ruling will taint genuine bonus stripping transactions.

Employing bonus shares as a tax planning mechanism is perfectly legitimate and does not inherently necessitate a GAAR analysis. Secondly, as a legal strategy, one cannot rely solely on a technical argument as the primary basis for standing before any court; there must be a robust, commercially grounded rationale for one's actions, ***Laxmeshwar*** adds.

> *Lastly, exercise extreme caution before invoking writ jurisdiction. Be cognizant that the chances of writ admittance are slim, and one risks adversely pre-judging the case, as exemplified here. This route should be pursued only if one is unequivocally certain there is no downside.*
>
> – ***Anand Laxmeshwar***
> *Partner, Bobby Parikh Associates*

The final word on this is yet to be spoken. Most experts believe the case will travel to the Supreme Court. Until then, deal makers shouldn't hesitate to use the bonus stripping provision as long as there's commercial substance.

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