
BALANCING THE SCALES: GAAR, LEGITIMATE TAX PLANNING, AND THE SEARCH FOR CERTAINTY IN INDIAN TAX LAW

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ABSTRACT

The enactment of the General Anti-Avoidance Rule (GAAR) under Chapter XA of the Income-tax Act, 1961, represents one of the most significant shifts in India's tax jurisprudence in recent decades. For the better part of seven decades, Indian tax law operated under the long shadow of the Westminster principle, the judicial endorsement of a taxpayer's right to arrange their affairs so as to attract the least possible tax liability. That principle, while never absolute, provided a degree of predictability that taxpayers and investors came to rely upon. GAAR fundamentally disturbs that equilibrium.

This paper examines whether GAAR strikes a meaningful balance between permitting legitimate tax planning and curbing impermissible tax avoidance. Through an analysis of the statutory framework under sections 95 to 102 of the Income-tax Act, the evolution of Indian judicial doctrine, the recommendations of the Shome Expert Committee, and comparative international practice—particularly the United Kingdom's Finance Act 2013 and the OECD's Base Erosion and Profit Shifting framework—this paper argues that while GAAR is a necessary and overdue legislative intervention, its broad drafting and the ambiguity inherent in its core concepts, particularly "commercial substance" and the "dominant purpose" test, create genuine uncertainty for taxpayers and investors.

The paper further argues that the institutional safeguards built into the framework—the monetary threshold, the Approving Panel procedure, the grandfather clause, and the excluded arrangements—while structurally sound in design, require more consistent and transparent application to fully realise their protective function. Without that consistency, GAAR risks functioning not as a principled anti-avoidance mechanism but as an instrument of revenue discretion. The paper concludes with recommendations for institutional reform rather than doctrinal revision.

1. INTRODUCTION

Taxation, at its most fundamental, is a matter of legal obligation. But law is a creature of language, and language has gaps. For as long as tax systems have existed, those subject to them have sought to navigate those gaps by arranging their affairs not to evade, but to avoid the incidence of tax by perfectly lawful means. The English courts endorsed this practice emphatically in *IRC vs. Duke of Westminster*,¹ where the House of Lords affirmed that every person is entitled to order their affairs so that the tax attaching under the relevant legislation is less than it might otherwise be. For nearly four decades in India, this principle formed the bedrock of tax planning advice.

That settled landscape began to shift following the Supreme Court's 2012 decision in *Vodafone International Holdings BV vs. Union of India*,² where the Court upheld a multi-billion-dollar transaction structured to avoid Indian capital gains tax. The government's response was swift and sweeping: the Finance Act, 2012, introduced both a retrospective amendment to the Income-tax Act and a statutory GAAR framework. Although GAAR was deferred several times due to investor concern, it ultimately came into force on 1st April, 2017.

The central question this paper addresses is: *to what extent does GAAR under the Income-tax Act 1961 strike a balance between legitimate tax planning and impermissible tax avoidance?* To answer this, the paper proceeds in five parts. Part II establishes the conceptual framework—distinguishing tax planning, avoidance, and evasion. Part III analyses how GAAR has altered the legal position on aggressive planning. Part IV examines the safeguards built into the GAAR framework. Part V surveys the Indian Judicial approach to planning-avoidance boundary. Part VI addresses the investor certainty issue. The paper concludes with a critical assessment.

2. CONCEPTUAL FRAMEWORK: PLANNING, AVOIDANCE, & EVASION

Before one can assess GAAR's calibration, the concept it seeks to regulate must be clearly delineated. The taxonomy of tax conduct exists on a spectrum, and conflating its categories produces both analytical confusion and bad policy.

A. Tax Planning

Tax Planning, in its most benign form, involves the arrangement of one's affairs in a

¹ *IRC v Duke of Westminster* [1936] AC 1 (HL) 19 (Lord Tomlin).

² *Vodafone International Holdings BV v Union of India* (2012) 6 SCC 613.

manner that takes advantage of provisions deliberately enacted by Parliament to incentivize certain behavior, such as investing in prescribed instruments, claiming depreciation, or structuring a merger within the framework of sections 391-394 of the Companies Act. The Supreme Court in *Union of India vs. Azadi Bachao Andolan*³ explicitly recognized that tax planning within the letter and spirit of the law is not only permissible but may constitute prudent commercial conduct. Critically, such planning does not violate the legislative intent; it conforms to it.

B. Tax Avoidance

Tax Avoidance occupies more contested terrain. It involves transactions that are technically lawful but whose design is directed at securing a tax outcome that Parliament did not intend or contemplate. The judicial articulation in *WT Ramsay Ltd. vs. IRC*⁴ marked a turning point in this regard; the House of Lords held that the Court must look at the composite effect of a pre-planned series of transactions rather than each step in artificial isolation. If the steps cancel each other out and only tax saving remains, the transaction may be disregarded. The Ramsay principle, though developed in the UK, has influenced Indian jurisprudence and the conceptual foundations of GAAR.

Indian courts, before GAAR, applied a more restrained version of this logic. In *McDowell & Co Ltd vs. Commercial Tax Officer*⁵, the Supreme Court, in a significant departure from Westminster, held that “tax planning may be legitimate, provided it is within the framework of law.” Justice Chinnapa Reddy’s minority opinion went further, suggesting that judicial approval of artificial avoidance devices was inconsistent with a welfare state’s fiscal imperatives. This tension between liberty to plan and the duty to contribute sets the stage for a legislative solution.

C. Tax Evasion

Tax evasion is categorically different from avoidance; it involves the intentional concealment of income, falsification of accounts, or fraudulent misrepresentation to

³ *Union of India v Azadi Bachao Andolan* (2003) 263 ITR 706 (SC).

⁴ *WT Ramsay Ltd v IRC* [1982] AC 300 (HL).

⁵ *McDowell & Co Ltd v Commercial Tax Officer* (1985) 154 ITR 148 (SC).

reduce tax liability. It is criminal conduct, attracting penalties and prosecution under sections 276C and 277 of the Income-tax Act. GAAR does not address evasion; the dedicated enforcement mechanisms already cover that ground. GAAR's domain is the grey zone between lawful planning and willful evasion, i.e., the arena of structured, artificial avoidance.

3. HOW GAAR HAS ALTERED THE LEGAL POSITION

Chapter X-A of the Income-tax Act, comprising sections 95 to 102, empowers the tax authority to declare an arrangement an "Impermissible Avoidance Arrangement" (IAA) and to recharacterize it for tax purposes. The statutory framework rests on four pillars.

A. The Definition of an IAA

Section 96 defines an IAA as an arrangement the main purpose of which is to obtain a "tax benefit," and which satisfies one or more of four conditions:

- (i) It creates rights or obligations not normally created between persons dealing at arm's length;
- (ii) It results in misuse or abuse of provisions of the Act;
- (iii) It lacks commercial substance or is deemed to lack it;
- (iv) Or it is carried out by means that are not ordinarily employed for bona fide purposes⁶.

The phrase "main purpose" is the fulcrum of the entire provision.

Unlike the "one principal purpose" standard adopted in the OECD's Principal Purpose Test (PPT) under the Multilateral Instrument⁷ India's GAAR demands that the tax benefit be the *main* purpose, with a slightly higher threshold. This is a meaningful distinction in practice; a transaction driven primarily by commercial logic but yielding incidental tax savings should, in principle, survive GAAR scrutiny. Whether the tax authorities apply this standard with sufficient rigour is a separate, and troubling,

⁶ Income-tax Act 1961, s 96(1).

⁷ OECD, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report (OECD Publishing 2015) art 7 (Principal Purpose Test).

question.

B. Commercial Substance

Section 97 defines when an arrangement shall be deemed to lack commercial substance. The indicators include- the substance or effect of the arrangement as a whole is inconsistent with or differs significantly from its legal form; it involves round-trip financing, an accommodating party, or offsetting elements; and it lacks a significant effect on the business risks or net cash flows of the party apart from tax effect.⁸ This is, in essence, a codification of economic substance doctrine developed in case law across multiple jurisdictions, including the United States⁹ and the United Kingdom.

The commercial substance test is the conceptual heart of GAAR, and it is also its most contested element. What constitutes a “significant” effect on business risks or cash flows is not defined, and the determination required the kind of nuanced economic analysis that tax officers are not always equipped or inclined to perform objectively. The Expert Committee on GAAR, chaired by Dr. Parthasarathi Shome, acknowledged this difficulty and recommended that the benefit of the doubt must flow to the taxpayer where the arrangement has any genuine commercial purpose.¹⁰

C. Consequences of Invoking GAAR

Where an arrangement is found to be an IAA, Section 98 confers broad powers on the Assessing Officer to disregard, combine, or recharacterize the arrangement; treat it as if it had not been entered into; look through the arrangement and treat its components as the separate steps they are; and reallocate income, expenditure, or relief between parties. These are sweeping powers, and their breadth is deliberate; that is, avoidance structuring is itself inventive, and the legislature has chosen to arm the revenue with equally flexible remedies.

D. Relationship with Treaty Benefits

One of the most consequential applications of GAAR concerns treaty benefits,

⁸ Income-tax Act 1961, s 97(1).

⁹ See *Gregory v Helvering* 293 US 465 (1935); Internal Revenue Code §7701(o).

¹⁰ Expert Committee on GAAR, Final Report on GAAR (Ministry of Finance, Government of India, 2012) (Shome Committee Report) para 4.3.

particularly the longstanding practice of routing through Mauritius to avail capital gains exemptions under the Indian-Mauritius Double Taxation Avoidance Agreement.¹¹ The Supreme Court in *Azadi Bachao Andolan* had upheld this practice, finding no abuse in choosing a treaty-favorable jurisdiction.¹² GAAR now allows the revenue to challenge even treaty-based positions if the arrangement lacks commercial substance and the main purpose is to obtain the treaty benefit. While the Indian-Mauritius DTAA was itself amended in 2016 to eliminate the capital gains exemption prospectively¹³, the broader point that GAAR can override treaty positions represents a significant recalibration of the taxpayer's position.

4. SAFEGUARDS WITHIN THE GAAR FRAMEWORK

A broadly-worded anti-avoidance rule without institutional checks is a blunt instrument that can cause collateral damage to legitimate commerce. The Indian legislature was aware of this risk, and the GAAR framework incorporates several safeguards, though their adequacy in practice remains debated.

A. The Monetary Threshold

GAAR applies only where the tax benefit in an arrangement exceeds ₹3 crore.¹⁴ This threshold is intended to filter out minor transactions and to concentrate the authority's attention on arrangements with material fiscal consequences. It also reduces the compliance burden on smaller taxpayers and businesses that engage in routine structuring. Critics have argued, however, that ₹3 crore is a relatively low bar for large corporates, and that the threshold does not adjust for inflation or transaction scale.

B. The Approving Panel

The most significant procedural safeguard is the mandatory reference to an Approving Panel before GAAR can be invoked. Under section 144BA, the Assessing Officer must first refer to the Principal Commissioner, who then refers the matter to the Approving

¹¹ Agreement for Avoidance of Double Taxation of Income and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains between India and Mauritius (signed 24 August 1982, as amended 10 May 2016).

¹² *Azadi Bachao Andolan* (n 3) [31].

¹³ Protocol amending India-Mauritius DTAA (signed 10 May 2016), art 1.

¹⁴ Income-tax Rules 1962, r 10U(1)(a).

Panel—a three-member body comprising a retired High Court judge and two senior revenue officials.¹⁵ The panel must provide the taxpayer an opportunity of being heard, examine the matter independently, and record its reasons in writing. Only upon the panel's approval can GAAR be applied.

This multi-tiered structure draws conceptual inspiration from the UK's GAAR Advisory Panel, though with important differences. The UK panel comprises an equal mix of tax practitioner and business representatives alongside government nominees, lending it a more balanced institutional character.¹⁶ The Indian Approving Panel's composition—dominated by revenue officials—has drawn criticism from taxpayer groups who question whether it can genuinely function as an independent check on assessing officer overreach.

C. Excluded Arrangements

Section 95(2) and Rule 10U of the Income-tax Rules, 1962, carve out specific categories of arrangements to which GAAR does not apply. These include arrangements where the tax benefit to all the parties in aggregate does not exceed ₹3 crore; non-resident investors in foreign institutional investors who have no permanent establishment in India; any arrangement that has been specifically dealt with in the Act itself (including arrangements subject to Transfer Pricing provisions); and arrangements entered into before 1st April 2017.¹⁷ The grandfather clause for 2017 arrangements has been particularly important in providing continuity for the existing investment structure.

D. Burden of Proof

The Act places the initial burden on the Assessing Officer to raise a GAAR issue and on the revenue to refer it upward. However, once an IAA is *prima facie* established, the burden shifts to the taxpayer to demonstrate that the arrangement is not impermissible. This bifurcated burden—common in anti-avoidance legislation globally—is a reasonable compromise. However, the asymmetry of information and resources

¹⁵ Income-tax Act 1961, s 144BA (1)– (4).

¹⁶ Finance Act 2013 (UK), Sch 43, para 10.

¹⁷ Income-tax Rules 1962, r 10U (1).

between the average taxpayer and a determined revenue authority should not be overlooked.

5. INDIAN COURTS AND THE PLANNING AVOIDANCE BOUNDARY

India's courts have navigated the tax planning-avoidance divide with varying degrees of confidence. The trajectory of judicial opinion reveals a shift from permissive endorsement to greater willingness to examine the purpose and substance of transactions—a trajectory that GAAR now gives statutory expression to.

The Westminster principle operated virtually unchallenged in India until *McDowell*, where the Court expressed discomfort with the idea that courts should be passive in the face of transactions structured to defeat the fiscal intentions of Parliament. Yet the majority in *McDowell* was careful to note that what was objectionable was not planning per se, but *colourable* devices—transactions with no purpose beyond tax avoidance.¹⁸

The tension between *McDowell* and the Westminster approach came to a head in *Azadi Bachao Andolan*, where the Supreme Court, in upholding Mauritius routing, explicitly held that the mere fact that a structure was tax-efficient did not make it impermissible, and that treaty shopping—while perhaps morally questionable—was not the same as fraud.¹⁹ This decision gave transaction planners considerable comfort, though it also intensified legislative pressure for a statutory response.

The *Vodafone* case crystallised the debate. While the Supreme Court found for the taxpayer on the specific facts, holding that the entire Cayman Islands holding structure had a genuine commercial purpose in the context of the group's global operations²⁰, the political and fiscal reaction was to conclude that judicial tools were insufficient to protect the revenue base, and that GAAR was necessary. Post-GAAR, courts will increasingly be asked to review the *legality* of GAAR invocations rather than the substance of avoidance itself—a shift in the locus of judicial inquiry.

¹⁸ *McDowell* (n 5) 178 (Chinnappa Reddy J).

¹⁹ *Azadi Bachao Andolan* (n 3) [34].

²⁰ *Vodafone* (n 2) [179]– [181].

6. GAAR AND THE INVESTOR CERTAINTY PROBLEM

Perhaps the most persistent criticism of GAAR is that its broad and open-textured formulation creates unacceptable uncertainty for taxpayers, particularly foreign investors who structure cross-border investments based on settled legal advice. Investment decisions are made years in advance, and they rely on legal frameworks that are predictable. A rule that can be applied retroactively—or unpredictably—to recharacterize transactions is, on this view, antithetical to the rule of law in fiscal matters.

The Shome Committee, appointed specifically to examine GAAR before implementation, acknowledged these concerns directly.²¹ It recommended that GAAR should be invoked only as a measure of last resort, that the purpose test should be read strictly to require the *dominant* (and not merely a principal) purpose to be tax avoidance, and that guidance through advance ruling

and circulars should be actively developed. Some of these recommendations were incorporated into the final rules; others were not.

The Authority for Advance Rulings (AAR), now replaced by the Board for Advance Rulings, following the Finance Act, 2021²² which in theory allows taxpayers to obtain binding rulings on proposed transactions before they are entered into. This mechanism significantly reduces the uncertainty GAAR creates, but access has historically been slow and the quality of rulings inconsistent. Faster, more accessible advance ruling mechanisms would do more to address investor concern than any revision of GAAR's text. The international dimension compounds this concern. The OECD's Action-6 report under the BEPS project introduced the Principal Purpose Test as a minimum standard for treaty abuse prevention.²³ India has ratified the Multilateral Instrument and adopted the PPT, meaning that treaty-based arrangements can be challenged under *both* domestic GAAR and the PPT simultaneously. The interaction between these two regimes—particularly the question of which prevails where they produce different outcomes—remains unresolved and represents a live source of legal risk for structuring advice.

²¹ Shome Committee Report (n 10) paras 2.4–2.7.

²² Finance Act 2021, s 95.

²³ OECD Action 6 (n 7) 27.

7. CONCLUSION

GAAR is a necessary legislative development. The pre-GAAR position—where artificial arrangements with no economic content beyond a tax saving could be insulated from challenge by the technical form in which they were clothed—was difficult to defend on grounds of either equity or good fiscal policy. Parliament was right to act, and the broad architecture of the GAAR framework, with its purpose test, commercial substance requirement, and mandatory Approving Panel, is broadly sound.

The balance it strikes, however, remains imperfect. The "main purpose" and "commercial substance" tests, while conceptually appropriate, leave considerable room for subjective and inconsistent application. The Approving Panel's composition raises legitimate questions about its independence. And the interaction between domestic GAAR and treaty-level anti-abuse rules creates a layer of legal complexity that the most sophisticated investor finds difficult to navigate with confidence.

What would genuinely improve the framework is not doctrinal revision but institutional strengthening: a more balanced Approving Panel with independent members drawn from the bar and industry; faster, higher-quality advance rulings; and clear CBDT circulars specifying categories of transactions that the revenue will not challenge under GAAR. Without these, GAAR will continue to be a powerful but unruly instrument—adequate to deter the most egregious avoidance, but insufficiently precise to protect the taxpayer who plans in good faith.

The Westminster principle has not been abolished; it has been conditioned. A taxpayer may still arrange their affairs to minimise tax—but only if that arrangement has commercial substance and is not structured with tax avoidance as its main purpose. That is, ultimately, a defensible position. Whether Indian institutions can apply it with the rigour and consistency that principled taxation demands remains the central, unanswered challenge.

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