Approach to Anti Avoidance in India Judicial & Legislative

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JUDICIAL APPROACH

- **Favourable treatment to Tax Avoidance as opposed to Tax Evasion**

  - Taxpayer's right to legal methods of tax avoidance recognised

  - Principle of liberal interpretation of incentive provisions

  - Principle of strict interpretation of charging provision

- **From Westminster to Bank of Chettinad to Raman and Co. To Azadi Bachao Andolan judicial authorities permitted tax avoidance within legal parameters**

- **Turbulence created by Mcdowell before Azadi Bachao Andolan**

- **IRC vs. Fisher's executors (1926 AC 395)**

  - Subject is entitled to so arrange his affairs as not to attract taxes, so far as he can do within law

- **IRC vs. Duke of Westminster (1939 A.C.I; tax cas. 490)**

  - Every man is entitled to order his affairs

  - Subject is taxable by plain words of statute and not in accordance with court's view of substance of the transaction

**English precedents
Relied on repeatedly by Indian Courts**

- **Bank of Chettinad vs CIT (1940 8 ITR 522 PC) – Law when constitution came into force**

- **Privy Council in Bank of Chettinad fully approved and followed dicta laid down in IRC vs. Duke of Westminster**

- **Principles laid down by Bank of Chettinad continued in terms of Article 372 of the constitution in absence of any abrogation by Act of Parliament or verdict of Supreme Court**

Avoidance – Not Illegal

- ◆ **Liberal interpretation of incentive provisions**

  - **Bajaj tempo ltd. Vs, CIT (1992, 196 ITR 188)**

    - Provision intended for promoting economic growth to be interpreted liberally

    - Conditions in incentive provisions to be construed so as to advance the objective of the section and not to frustrate it

- ◆ **Strict application of charging provisions**

  - **CIT vs. Ajax products ltd. (1964, 55 ITR 741)**

    - Subject is not to be taxed unless charging provision clearly imposes obligation

    - If words of a statute are precise and unambiguous, they must be accepted as declaring express intentions of the legislature

    - No room for any intendment. No equity about tax

    - Nothing is to be read in, nothing is to be implied

Avoidance – Not Illegal

♦ **CIT vs. A. Raman & Co. (1967, 67 ITR 11)**

- Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited

- Legislative injunction in taxing statutes may not be violated but may be lawfully circumvented

♦ **CIT vs. B.M Kharwar (1968, 72 ITR 603)**

- Followed Bank of Chettinad vs. CIT

- Legal effect of a transaction cannot be displaced by probing into the "substance of the transaction"

♦ **CIT vs. Calcutta Discount Company Ltd. (1973, 91 ITR 8)**

- Followed CIT vs. A. Raman & Co.

- Assessee can arrange his affairs to minimize tax burden

- **Mcdowell & Co. Ltd. Vs. CTO (154 ITR 148) (SC)**

  - Changed concept of fiscal jurisprudence in country

  - Any tax planning intended to and results in tax avoidance must be struck down

- **Justice Chinnappa Reddy**

  - Ghost of Westminster has been exorcised

  - Proper way to construe a taxing statute is to ask whether transaction is device to avoid tax and whether judicial process may accord approval to it

- **Justice Ranganath Mishra**

  - Tax planning may be legitimate provided it is within the frame work of law

  - Colourable devices cannot be part of tax planning

  - Every citizen is obliged to pay taxes honestly without resorting to subterfuges

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- **Avoidance – Not immoral**

  - Arvind Narottam (1988, 173 ITR 479) (SC)

    - No amount of moral sermons would change people's attitude to tax avoidance unless government un-useful spending is stopped

    - Where true effect of transaction is clear, appeal to discourage tax avoidance is not a relevant consideration

- **Avoidance – Classified within law**

  - Banyan & Berry vs. CIT (1996, 222 ITR 831)

    - Every bonafide act reducing tax liability not colourable device

  - M.V. Valliappan vs. ITO (1988, 170 ITR 238)

    - Every attempt to reduce tax cannot be rejected

    - Legitimate attempt to reduce taxes is permissible

- **UOI vs. Azadi Bachao Andolan (263 ITR 706) (SC)**

- **Principles laid down on treaty shopping and on tax avoidance :**

    - Court to decide what law is, and apply it; not to make it - *Judicis est jus dicere*

    - An Act otherwise valid in law cannot be treated *non-est* based on underlying motive

    - In absence of limitation clause, such as one in Indo-U.S. Treaty, resident of a third nation cannot be denied benefits of a Treaty

    - Whether Treaty shopping should continue is discretion of 'Executive'. Court not to judge legality of Treaty Shopping.

- No equity in fiscal statute. Either statute applies *proprio vigore* or it does not. Fiscal statute cannot be applied by intendment

- Madras HC rightly concluded in **M.V. Vallipappan and others v. ITO** that McDowell cannot be read as laying down that every attempt of tax planning is illegitimate

Principle of Duke of Westminster alive, notwithstanding temporary turbulence created by McDowell

Mcdowell – Dead or Alive?

- Curative petition filed for review of ruling in UOI vs. Azadi Bachao Andolan

- Pronouncement by new UPA government in common minimum programme to the effect that " misuse of double taxation agreements will be stopped"

LEGISLATIVE APPROACH

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- **Reactive not proactive**

  – Loopholes generally plugged when misuse noticed

- **Law formulated or amended to**

  – Provide for taxes/refuse set-offs in case of wide spread misuse – actual, perceived or even potential

  – Overcome lack of effectiveness of 'executive'

  – Nullify effect of judgements permitting tax planning within law

  – Provide wider powers to 'executive' to reopen, prosecute or penalize

- **Amendments may even result in limited double taxation; but ensures no double deduction**

- **Not entirely consistent**

  – Soft corner for tax avoidance

- ♦ **Widespread avoidance of capital gains tax by transferring property by way of 'power of attorney'**

  - Definition of 'transfer' in relation to a capital asset amended in 1987 to include

    - Transactions in the nature of power of attorney arrangements; &

    - Possession in part performance of contract, referred in section 53A of transfer of property act, 1882

  - Circular 495 : amendment brought in to prevent avoidance of capital gains tax

- ♦ **Sale & lease back transactions used as tax planning device to reduce finance cost**

  - Buyers claimed depreciation on the assets purchased at prices higher than fair market value

  - Explanation 4A to section 43(1) inserted in 1996 to provide that depreciation to buyer would be allowed on written down value in hands of seller

♦ **Non resident shipping companies allocated higher amounts to demurrage or handling charges that were out of Section 44B**

  – Section 44B initially applied only to receipts for carriage of passengers, live stock, etc.

  – Finance Act, 1997 inserted Explanation to section 44B w.r.e.f April 1976 to bring in charges by way of demurrage or handling within the ambit of Section

  – Memorandum to Finance Bill, 1997 categorically states splitting of receipts by assesses as reason for amendment

Section retrospectively amended without specifying the exceptions

- **Salaried employees used to set-off salary income with business loss**

  - Finance Act, 2004 inserted sub-section 2A to section 71 providing that set-off of business loss against salary income will not be allowed prospectively

  - Memorandum to Finance Bill, 2004 clarifies that this has been brought in to prevent abuse of provisions of set off of losses

- **'Gift ' used as tax planning device**

  - Finance Act, 2004 included receipt of 'gifts' by individual/HUF from unrelated persons in excess of Rs. 25,000 in definition of income

- ♦ **Wide spread practice of purchase of securities cum dividend and sale thereof ex dividend soon after the record date enabled traders to book business loss while receiving exempt dividend**

  - – Finance Act, 2001 amended law to provide that loss on sale of securities <u>acquired within 3 months</u> prior to record date and <u>sold/transferred within 3 months</u> after record date to be ignored to the extent of exempt income

  - – Finance Act, 2004 further deterred tax avoidance by increasing the period of holding securities after record date to 9 months

Amendment due to perceived avoidance of tax Dividend not really exempt

Overcoming Lack of Effectiveness of 'Executive'

♦ **Problems faced in assessing and recovering taxes from persons trading in country liquor, timber and forest produce**

  – Finance Act, 1988 introduced section 44AC for levying tax on presumptive basis while section 206C for recovering tax from persons trading in country liquor, timber and forest produce

  – Section 44AC was later omitted w.e.f April 1993 due to controversial interpretation & administrative difficulties

  – Circular 528 dated December 16, 1988 clarifies that amendment was brought in due to difficulties in assessment and recovery from persons engaged in such business

♦ **Section 10(22) and (22A) granting exemption to educational & medical institutions were removed by Finance Act, 1998**

  – Memorandum to Finance Act, 1998 : provisions were omitted due to misuse in absence of monitoring mechanism

Wider Powers to Prosecute/penalize

♦ **Finance Act, 2004 inserted section 277A**

- Falsification of books or documents etc. To induce or abet any other person to evade tax, penalty or interest, punishable with imprisonment

- General intent sufficient. Not necessary to prove instance of actual evasion of tax, penalty or interest

- **Explanations 3 to section 43(1) – Though inserted to curb tax avoidance ; may result in double taxation**

- **Section 14A : expenditure incurred in relation to exempt income**

  - Assessee claimed deduction of expenses incurred in earning exempt income against taxable income

  - Denial of expenses since exempt income not taxed on net basis

- ♦ **Transfer pricing provisions**

  - Adjustment in profits of Indian enterprise by AO without corresponding adjustment in counter party may lead to double taxation

- ♦ **Section 40A(2)**

  - Expenditure in respect of which payment is made to specified person, if found excessive, disallowed

- ♦ **Section 40A(3)**

  - Expenditure in respect of which payment exceeding Rs. 20,000 is made otherwise than by crossed cheque or crossed draft, 20% of such expenditure disallowed

- **Section 60 to 64 - curbs tax avoidance by including income of other persons in assessee's total income**

- **Section 93 – guards against avoidance of tax by transactions resulting in transfer of income to non-residents**

- **Explanation 5 to section 32 – deals with compulsory allowance of depreciation irrespective of whether assessee has claimed it or not**

- **Powers to AO to replace price of capital asset sold with fair market value - section 52(2)**

  - Introduced by Act 5 of 1964 w.e.f. 1.4.64

  - Omitted by Finance Act, 1987 w.e.f. 1.4.88

- **Acquisition of immovable properties to counteract tax evasion**

  - **Chapter XX-A**

    - Introduced w.e.f. 15.11.72

    - Inoperative after 30.9.86

  - **Chapter XX-C**

    - Introduced by Finance Act 1986 w.e.f. 1.10.86

    - Inoperative after 01.7.2002

Accept Defeat from Tax Avoiders / Evaders

- **Voluntary disclosure of income schemes**

- **Settlement commission**

- **Samadhan**

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- **Section 158BF**

  - Certain interest and penalties not to be levied or imposed when the undisclosed income is determined assessed as part of Block Assessment

    (Not operative w.e.f. 31 May 2003)

- **Explanation 5 to section 271(1)(c)**

  - No penalty for concealment if assessee admits of concealment and pays tax and interest on concealed income disclosed during the course of search