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ROLE OF INDIAN JUDICIARY IN PREVENTING INTERNATIONAL TAX EVASION - AN ANALYSIS

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ROLE OF INDIAN JUDICIARY IN PREVENTING INTERNATIONAL TAX EVASION - AN ANALYSIS

Deepak B. D.*

[*Abstract:* *It is to be specifically noted that the judiciary plays and active and proactive role in the interpretation of statutes and administration of justices. Especially when it comes in the matter of taxes and international taxation the tremendous work done by the judiciary is highly appreciable because the independency of judiciary and judicial review are the basic structure of the constitution of India and right to free and fair trail are the fundamental rights and a basic human right. The principles of separation of powers are one of the foundation stone of the justice delivery system which is still following in our country. The judgments discussed are some of the landmark decisions render by the judiciary of the Hon'ble Apex Court of India. These decisions give us an insight significance of judicial decision, knowledge & efficiency and active role of the judiciary.*

*When it comes to the nation's revenue and financial importance the judicial decision is the last resort as it provides classifications and interpretation in the law of the land. The general rule is that taxing statues are always a strict in nature and the interpreting it in stricter sense is the principle mandate. Because in some cases it deals with the taxing right of one country but other cases two or more countries tax sovereignty is questioned. The essence of international law and mutual cooperation between the countries and foreign ties is to considered while dealing with tax matters. At sometimes tax revenue is compromised in the common interest on par with the individual interest.***]**

I

Introduction

Taxation is always a matter of complex subject, as it tends to decide and fix the tax liability, exemption and taxable power of an authority. The constitutional Courts are empowered with issuing the writs and administering the justice in the best interest of the litigants. They follow liberal, harmonious, beneficial interpretation while deciding the cases. The Indian judiciary had time and again ensured that the litigants have approaching it after aggrieved and exhausted all the possible solutions.

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So somehow, it considers to mold the relief and deliver the justice. But, whenever the dispute regarding the taxation is challenged before the judiciary, it wants to balance the two parties' interest and right. The right of the tax authority/government is to be balanced on the one side and the person who challenging such tax claim on the other side. Here for the government, taxation is the sovereign right which is the main source of revenue for the public spending. But for the litigant, who question's such order or tax notice of the authority is concerned aggrieved by the assessment or computation of the formula involved as he feels it an arbitrary one. So bridging the gap is required as and when and also the general rule is strict interpretation of taxing and penal statues to be followed. The judiciary in general and the Supreme Court in particular has acted in a neutral way and notably in the Vodafone company income tax notice case (as mentioned below) the court interpreted, the provision of indirect transfer of foreign shares by a foreign entity is no way related to the jurisdiction of Indian Income Tax Authority, is a classic case and of its kind. It may still remember in the walls of the Supreme Court, and remember its glory.

***Vodafone International Holding B.V.* v. *UOI & Anr*[1].**

Facts:

Before 1999 there was a system called as the grant of licensing or license system for the telecommunications industries. But in the year 1999 this was scrapped and discontinued by the government. This had created a huge growth of the telecoms and impacted the economy as well. At that stage the Hutchison Telecom international Limited, which is a holding company situated in Hong Kong incorporated its subsidiary company in India as Hutchinson Essar Limited. Another company which was managed and controlled by the parent Hutch Company called as the CGP investments holdings ltd; situated at the Cayman Island. The Hutchinson Essar subsidy company was not directly controlled by the parent company, but it was managed and controlled by the CGP Investments and Holdings. For better understanding the company which is situated in Cayman Island is controlling the company in India. The link between the parent company and the subsidy company is the

[1] *Vodafone International Holding B.V.* v. *UOI & Anr* Civil Appeal No.733 of 2012.

CGP holdings. It manages all the affairs of the Hutchinson Essar Indian company. As far all this parent company transferred its 67% of its shares in the Hutchinson Essar to the holding company CGP investments in Cayman Island. This Hutchinson Essar was running and operating the business of providing the telecommunication services to the Indian subscribers. The parent company Hutchinson decided to leave the business of telecommunication in India during 2007. At that period the Vodafone International holdings which is a Netherland based telecom company entered the Indian markets for telecom business. The Vodafone Groups of company and the Hutchinson Telecom parent company had entered in to an agreements that to transfer of the 67% of the shares of the Hutchinson Essar Ltd vested with the CGP Investments to Vodafone Holding company[2] which is a subsidy Group of Vodafone, as a result the exchange was 11.1 billion dollars.

During the transfer of shares and exchange of consideration both the parties believed that the capital gains taxes in India would be exempted/not charges because of the residential status of both the companies and the jurisdiction of the transactions involved. As far as the residential status are concerned both the companies are not a resident of India, Vodafone Company is Netherland based and Hutchinson International Ltd is Hong Kong based company and jurisdiction of taxes are concerned transactions of both the companies taken place outside India. At the point of such transfer no law was inforce for the imposition and levy of taxes for the indirect transfer of assets on International transactions and later the Income tax authorities came to know about the transfer of shares and capital gains. A show-cause notice was issued by the IT authorities to the Vodafone company[3] on 06th August, 2007 U/d sec. 165 of the Act[4] (for the sake of brevity in short the Act) as the reasons why shouldn't Vodafone be considered an assesse under default for the transfer of Hutchinson Essar Indian company. The Assistant Director of I.T. Mumbai has also issued a statutory notice[5] for the failure to withhold taxes from the Hutchinson Essar. Later on 19.09.2007 the actions of the I.T. authorities was contested by the company in the High Court of

[2] *Vodafone International holdings*
[3] *Vodafone Essar Ltd*
[4] *Income Tax Act 1961.*
[5] *u/s. 201(A) and 201(1A) of the IT Act.*

Bombay taking a ground of, lack of proper jurisdiction by the Indian tax authorities.

Verdict

The Bombay High Court decided the case on merits and come to the conclusion that the international business transfer between the Hutchinson[6] and Vodafone[7] involving of a control of Interest i.e. the management and control of operation and transfer of shares. The 67% of shares involving a huge decision-making factor of the administration of the company and transfer including the rights, capital assets and other entitlements.[8] The Court has made an observation that the transaction has not taken place within the jurisdiction of India but it totally dealing with the transfer of assets which is located within the jurisdiction of India and the I.T. official's claim of capital gains taxes on the proposed tax payer Vodafone. The forum thus made a note that the sec.9(1) (i) of the Act is applicable in the particular case, which states that the income arising or accruing directly or indirectly connected with any business which is obtained by the sale of properties situated in India, either directly otherwise indirectly. The court applied the principle of nexus and objects of the intended transaction u/s. 195 of the Act the assets situated in India is transferred had created a nexus for the tax authorities to initiate proceedings. The Court ruled that the Act is extraterritorial operational in nature and attracts against the non-residents, if transaction made is in nexus in India. The Bombay HC had dismissed the case of the Vodafone and stated that, the I.T. authorities having jurisdiction in respect of the assessee to impose taxes. The Court further made a remark that the Vodafone can make their case before the tax authorities by submitting an explanation to that effect that it has an reason and genuine belief that the transaction is not subject to taxes and so no TDS is deducted and accordingly no such penalties or penal liabilities arises. The HC's findings have been appealed in the Hon'ble Apex Court for its interference and to set aside.

[6] *Hutchinson Telecom International Limited*

[7] *Vodafone International Ltd*

[8] *u/d s. 2(14) of the Act*

Supreme Court's Verdict

In an unexpected move the findings of the Writ Court was struck down by the Supreme Court of India by making some remarks, that transferring the controlling interest and alienating the share is not a separate transaction, as it forms an inevitable role in transfer of shares. Authoritative interest over a company is inherited statutory right and not a proprietary right, and an acquiring of shares will bring controlling interest that cannot be separately treated as taxable. The Court observe that the sec. 195 applies only to resident and cannot have an extraterritorial operation. The transaction taken between the 2 non-resident companies and which occurred outside India and does not having any direct nexus with Indian jurisdiction. Section 9 (1) (i) of the Act considers revenue received solely via the sale of a capital asset located in India, and does not include revenue obtained as a consequence of an indirect transfer of capital assets. The judgment was authored by the bench consisting of S.H. Kapadia, the then Chief Justice of India, Justice K.S. Radhakrishnan and Justice Swatanter Kumar and held that

> "*the Applying the look at test in order to ascertain the true nature and character of the transaction, we hold, that the Offshore Transaction herein is a bonafide structured FDI investment into India which fell outside India's territorial tax jurisdiction, hence not taxable. The said Offshore Transaction evidences participative investment and not a sham or tax avoidant preordained transaction. The said Offshore Transaction was between HTIL (a Cayman Islands company) and VIH (a company incorporated in Netherlands). The subject matter of the Transaction was the transfer of the CGP (a company incorporated in Cayman Islands). Consequently, the Indian Tax Authority had no territorial tax jurisdiction to tax the said Offshore Transaction."*[9]

The court also observed that the act done by the Vodafone Inc. is inside the scope of tax-planning and this technique was adopted by several foreign companies situated at Mauritius and Cayman Islands and this has been adopted by the Vodafone and Hutchinson group for the legitimate tax planning. SC stated that the ***"Doctrine of Piercing the***

[9] *Vodafone International Holding B.V.* v. *UOI & Anr* Civil Appeal No.733 of 2012 (Arising out of SLP (C)) No.26529 of 2010), dated: 20 January 2012, Para-90.

Corporate Veil" can be applied if the transaction made was a clear case of tax avoidance, the act is not a colourable device and not made to avoidance of taxes. Therefore, Vodafone is not forced to reply the authorities u/s. 163 of the Act. Bombay High Court judgment was struck it down by the Apex Court and stated that the authorities does not have any competence to impose capital gains tax of Rs. 12,000 crores and the appellant is protected from all the liabilities in the case.[10]

Impact of the Judgment of Supreme Court:

Government wanted that the transborder transactions should be taxed and revenue loss should not occur on the offshore dealings, by bringing such activity into taxation web. Pranab Mukherjee has clarified that, "The Government wants to make three points quite clear, that India is a not a 'no tax' or 'low tax' or even a 'tax haven.' In India, all taxpayers, whether resident or non-resident, are to be treated at par. Also, India is a country, where you are exempted to pay taxes if you have paid taxes in some other countries as it is covered by DTAA (double taxation avoidance agreement). But it cannot be a case that you pay no tax at all". Double taxation can be avoided but evasion of taxes is not tolerated at all. There was a need to bring tax certainty and to bring general anti-avoidance rules into focus.

After the judgment of the Supreme Court it had created huge impact on the Indian Government, which resulted in the introduction of finance bill 2012 and by making amendments in the following sections under;

1.Explanation no. 5 was interested[11]

It states that transferring a foreign stake having a considerable value of assets shall be taxed in India, this may be effective from 1962 (i.e. a retrospective amendment).

2.Explanation no. 2 was inserted[12]

The section clearly states that, either assets unconditional or conditional, direct or indirect, willingly or unwillingly, by way of an arrangement (entered either inside or outside India) or shall be treated as a transfer.

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[10] *Ibid, 6 SCC 613.*

[11] *Sec. 9 (1) (i) of the Act.*

[12] *Sec. 2 (47) of the Act.*

3.Expanded explanation[13]

It made clear that the assets include any conferred right by the Indian Company having right of control and management.

4.The scope under Sec. 195 of the statue was expanded.

It applies both to the residence and non-residence whatsoever having business association or any existence tax shall be deducted at source.

The retrospective amendment passed in the parliament as a law, had completely made the nullity of the judgment of the Apex court in Vodafone Case, stating a reason that to raise the tax revenue and considering the welfare of innocent tax payers which reduce the burden imposed on them.

Now the situation had become more miserable because during the legal battle in Hon'ble Higher Judiciary of India and High Court, that the absence of provision or no valid provision in the Act, but now the parliament had amendment the Act by exercising the parliamentary supremacy an English Doctrine. When there is a clash or dispute between the Judicial Independence and Parliamentary Supremacy the Courts may adopt a view of harmonies construction. Now Vodafone has no other option as the highest court of the country is itself prevented form entertaining the petition, so it moved the permanent court of arbitration, by invoking Art. 9[14]. The specialization in the Article is the parties to the Treaty can approach the permanent court of arbitration to adjudicate their issues between the investor of either country and other state parties of the contract.

Decision of the Permanent Court of Arbitration (PCA):

After careful perusal of the facts and materials available on records the PCA held that imposition of taxes by way of the retrospective amendment would amount to breach of conditions and clauses of the Art. 4(1) of the Treaty which requires[15]. The counter claim submitted by the UOI was thus rejected challenging the validity of the Vodafone petition. The Tribunal had ordered a bar to the Indian Union from levying taxes from Vodafone, the petitioner and also in addition direct

[13] *Sec. 2 (14) of the Act.*

[14] *Bilateral Investment Treaty entered between the Netherland and India.*

[15] *Equitable and fair treatment mentioned under Bilateral Investment Treaty.*

the respondent UOI obligated to pay the company as part of costs and compensation to the proceedings a sum of Rs. 40 crores.[16]

The Finance Bill 2021

After approaching all the forums and unable to win the battle and received a call from all the Nations and International Forums the Union of India had determined to propose the bill[17] which solve this ambiguity of retrospective amendment and which makes the amendment as nullity. This Bill during the discussion of the Parliamentary Debate stated that various stake holders negatively criticized this act and the Investment in the Country has also reduced for the few years.

Sec. 9 (1) (i) of the Act, 1995

"The amendment changes the state of the finance bill 2012, assets or capital assets, which is held by a non-resident by way of investment, directly or indirectly shall be taxable post April 2012."

Note: which means that the retrospective imposition of taxes is removed and repealed by way of this above amendment.

Sec. 119 of the Act, 1995

Insertion of a new provision stating the 1st and 2nd proviso in the above section shall cease to be applied on the fulfilment of certain condition ***"such as withdrawal or furnishing of undertaking for withdrawal of pending litigation and furnishing of an undertaking that no claim for costs, damages, interests, etc."***. The Government by making the following amendment has waived the tax liability of the Vodafone Holdings.

Analysis of the case

Taxes are the financial sources of the country, with them the economic condition of the poor are uplifted and the burden on the downtrodden is eliminated. Taxes is an essential source of revenues for the government to fulfil the goal of welfare state and implement the policy of the directive principles. The redistribution of wealth and the confirming the meal of each and every one by providing the ration distribution system by way of fair price shops. Each year the losses from

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[16] *Permanent Court of Arbitration (PCA) at The Hague in Vodafone International Holdings B.V. v. India, PCA Case No. 2016-35 (Award dated 25 September 2020).*

[17] *The bill proposed for nullifying the retrospective taxation provisions introduced by the Finance Act, 2012.*

these public welfare are compensated by the annual budget expenses. The taxes from other sources are allotted and deposited in the account of the welfare schemes and public benefits. The public transports are the one of the department among others which is facing huge losses, but it is not a business to calculate the profits and losses. It is a public utility services, the department is itself is created to serve to the public in-spite of the losses.

But now a days the taxes so imposed and collected are creating a fear and burden in the minds of the public, instead it should make people to feel secure. There is a justification on the side of the government but the overall taxes collection ration contribute towards the indirect tax system, in which the poor, un-skilled employees and unprivileged sections of the society is contributing most of their earnings. In upcoming days, the government should bear in mind about these sections of people before formulating any new taxes in the law. The taxes and the tax structure should boost the economy and increase the free flow of capital and increase the GDP of a nation. The one on the other hand is the retrospective taxation which creates uncertainty among the assessee and the tax payers and impact the foreign investment negatively. The above case is a classic example of the retrospective taxes imposition and collection, due to the same the FDI has been reduced and foreign companies avoid to invest in India and the exiting foreign companies left for India to some other countries. The proper non-application of mind and the violation of Art. 265[18] which resulted in the withdrawal of the Finance Act 2012. When the intended international transaction of indirect transfer of capital assets and shares taken place outside the jurisdiction and also the law was not existence to impose taxes on the indirect and unrelated transfer. The failure to consider this and improper appreciation of the facts of the case has resulted in the retrospective amendment and the withdrawal of the same with lot of criticism.

Even though the findings render by the HC of Bombay was erroneous on the interest of the nation tax revenue, but the Hon'ble Apex Judiciary had made a balance between the nation interest and the protection of the foreign investors. The SC stand regarding the transfer of shares is a

[18] *Constitution of India, 1950.*

subsequent event of transferring the controllable interest and management is highly appreciable. The I.T. Act does not have any extra-territorial jurisdiction is also make that the SC has perused all the documents and settled proposition of law in legal sense. The Vodafone Group had only used the advantages of Bilateral Investment Treaty and not evaded the taxes was rightly considered by the Permanent Court of Arbitration and render a findings to the Vodafone Group that the taxes collected shall be refunded.

Hence from this case 2 things can be taken in to account, 1st is the unfair and unjust law legislated by law makers for the interest of the innocent tax payers as the huge amount of taxes on capital gains has to be loss towards the government and the 2nd thing is the independence of judiciary, the judiciary has stand still all along its way to protect the justice and equity of the law of the land and genuine litigants.

1.1. McDowell and Co. Ltd. v. *Commercial Tax Officer*[19]

Facts of the case

The learned counsel for the petitioner states that, McDowell is a company which is incorporated in Hyderabad holding a valid license for the manufacturing of liquors and running a distillery plant in the said unit. The company had a practice of selling the liquors to their sellers without paying the excise duty, but had a condition precedent that the purchaser should pay the same before collecting the liquor by producing the receipts. Not only that but the company had also another practice that while making bills it also exclude the excise duty that the purchasers paid and the bill contains only the price of the commodity which reduces the company from paying additional sales taxes for the excise duty. It simply makes clear that excise duty is also a tax and by adding the amount in the bill as a result the total taxable amount will be the actual cost of the commodity along with the excise duty. This creates an cascading effect on taxes tax on tax. Additional sales tax on excise duty. So the company cleverly excluded the excise duty paid by its customers/purchasers by issuing a bill to the effect that only including the cost of the liquor to avoid paying the excess of sales taxes.

[19] (1985) 3 S.C.C. P-230.

The company has doing this practice to reduce its liability of tax.[20] Under,[21] the rule provides the excise tax is to pay by the manufacturer and it is to be included in the turnover. But the company had however not followed and shifted their burden to the purchasers as an arrangement between them. At that time the tax officials came to know about the practice of the company and made a search operations with respect to the relevant assessment year. They also find that the accounts book maintained by the company does not disclose any payment of excise duty paid. The company provided an explanation that the purchasers of the liquor they themselves paid the excise tax and collected liquor form the distillery after producing the receipts for the same. After getting this explanation the authorities checked the books in regarding the excise payment by the customer but there were not sufficient materials or records to prove the same and books does not contain such information.

Taxing authority after taking all the relevant information and other circumstances came to the conclusion that assessment should be conducted and issued a notice to show cause, that why, assessment shall not be conducted for not paying the sales taxes by the company. The company challenged the said showcase notice and its validity stating the ground as the duty paid by its purchasers is not a part of profit of company. The respondent's counsel stated, the main contentions of the respondents i.e. the state is that, under the Act,[22] it is the duty of the producer to move the liquor out of the distillery once the excise duty is paid.

But failing to fulfil the existing proviso of the Act the petitioner's company allowed the purchasers of the liquor to do the payment of the excise duty by themselves for removing the liquor from the distillery. The actual cost including the profits were collected from the purchasers but the payment of excise amount by the buyers were not added in the bills and shown as a profits, it was intentionally excluded by the petitioner company. The company was adopting this practice in same

[20] *"Rule 76 & 79 of Andhra Pradesh Distillery Rules, as notified under the Andhra Pradesh Excise Act, 1968."*

[21] *"Sec. 2(s) of the A.P. Sales Tax Act, 1957."*

[22] *Andhra Pradesh Excise Act 1968.*

manner without adding the excise tax paid by its buyer in the total profits and paying the sales taxes only on the turnover of the company.

The Revenue/respondents submitted that the assessee/petitioner had failed to pay the entire taxes and paid the taxes excluding the excise duty which is also the part of the profits. Here it is to be considered that the turnover/total sales includes the manufacturing costs, excise duties, transportation charges and secret formula expenses and other ancillary expenses and incidental charges to be the total amount of turnover of the company and to this amount the company had to pay the taxes but the company adopted a colourable means by shifting their burden upon the purchasers/third party to pay their taxes, which by results in the reduction in the taxes paid to the government. This created a revenue loss towards the company.

Judgment of the High Court

The petitioner challenged the validity of the notice in the Hon'ble Andhra Pradesh High Court stating the above mentioned grounds and contentions and the respondent contested the case on merits and placed augments on their side. After hearing both sides and perused the materials available on records the Honourable High Court of Andhra Pradesh was pleased to dismissed the Writ Petition stating that the notice issued by the Revenue does not find any perversity and interference by this court is not needed and this petition ultimately fails and lacks merits both on the facts as well as the grounds.

Feeling dissatisfied the company appealed in the Hon'ble Apex Court. The Supreme Judiciary's Division Bench looked into the existing excise and sales tax laws with regard to the assessee grievances and the revenue respondent's contentions. The Court made the following observations in this regard and stated that

a) The buyer also have a responsibility to pay the excise duty.
b) The purchaser's excise duty payment is not included in the liability of assessee.[23]

Based on the observations made by the SC and the arguments advanced by the counsels on either side the forum held that the tax of excise taxes paid by the buyers of the assessee directly to the government, should

[23] *Ibid 19.*

not be forced to include in the books of accounts and force to pay the additional taxes on the sales.

Latter developments in the Law

After the verdict of the Apex Court in earlier judgment[24] the Andhra Pradesh Distillery Rules were amended by the Andhra Pradesh government. The amended Rule makes clear that the tax levied on excise shall be paid by manufacturer, the company does not take the rule seriously and continued the practice as done in the earlier case by payment of excise duty by the purchasers itself. As per the amended Rule the Revenue Authorities claimed the tax liability of the assessee by including the excise duty in turnover towards the sales taxes. By issuing a notice for the act of the assessee by the revenue authorities for stating the reason. Again, the company approached the AP, HC for setting aside the aforesaid notice as unsustainable. But the HC held that "the turnover of the company related to the supply of liquor is to be computed by including the excise duty paid and it has to be paid by the Rules contemplated under the Act. But an arrangement was entered between the company and the purchasers, the purchasers are paying the excise duty. Even though the excise duty is paid by the purchasers the net turnover had to be included in the books of accounts of the company. The liability of the company to include the excise duty in the net turnover before paying sales taxes." So the Writ Petition lacks merits and fails and the notice issued by the revenue finds to be need not be interfered and no perversity. Hence this writ petition is dismissed and disposed of accordingly.

Decision of the Hon'ble Apex Court

Unsatisfied by the judgment of the HC of AP the company preferred appeal in the SC by way of a special leave to appeal (civil)[25] by challenging the order. The case was argued by citing the earlier order of the court passed in the matter of same parties as a precedent. But the court was not convinced and it had referred the case to the constitution bench. The multiple acts done formerly by the assessee company which were neither been treated as taxable is now taxable based on the analysis and findings of the larger bench (constitution Bench of the Hon'ble

[24] *McDowell & Co. Ltd. v. CTO (1977) 1 SCC 441.*
[25] *Ibid 19.*

Supreme Court). Only issue before the court is that, whether liability of the assessee in paying the excise duty by himself or by the purchasers of the liquor *(i.e. excise tax payment by the assessee and added in the company's turnover for paying the sales tax)*. The constitutional bench after referring all the relevant precedents related to excise duty and decided that; "the incidence and imposition of excise duty is directly relatable and in connection with the manufacturer and the payment is also the primary & exclusive obligation of the manufacturer". The only remedy is that the collection of excise duty can be deferred at later stage for the convenience in payment.

The court on considering all the facts and material placed on record before it had examined all the settled proposition of law relating to the issues and find an error on its earlier decision delivered by it on 1977 Mc Dowell case and over ruled it by the present judgment. With regard to the turnover of the company, the court has referred all the National and International judgment and stated that the consideration received by the seller from the purchaser is inclusive of excise duty during the purchase of liquor and it is to be added in the turnover of the assessee even though it is straight away paid by the purchaser to the excise department. By rendering this verdict, the SC had over ruled its earlier decision in the year 1977 McDowell case and the company lost the case and the court has not discussed about tax evasion or avoidance of the company and ruled that sales tax to be paid on the turnover including the excise duty.

Observation made by judges

The judgment authored by Justice Ranganath Mishra written a for the majority view (for himself and on behalf of other three judges) is that, while making a response towards the arguments of the appellant company "it is open to everyone to make a formula or adapt a business procedure so as to reduce the tax burden to the less and which not result in the tax evasion". The appellant by supporting their arguments placed reliance on certain decisions.[26]

"The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the

[26] *"CIT v. A. Raman & Co. (1968) 67 ITR 11 (SC) and CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC)."*

device and to determine the true character of the relationship. But the legal effect of a transaction cannot be displaced by probing into the 'substance of the transaction'."

From the above it is known that the authorities are empowered to find the nature and characteristics of a transaction i.e. whether lawful or unlawful but they are not to do so the act of investing the purpose of the transaction. While applying this to the case of McDowell we can understand that the authorities are do the act of checking the nature of transaction as tax evasion or tax avoidance but they are not to do the act of finding the object and intention of the transaction.

Then, Justice Ranganath Mishra responded by citing the judgment in *CIT* v. *Vadilal Lallubhai*[27]

"45. Tax planning is considered to be legitimate provided, only it is within the framework of law. Colourable devices or acts involving cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of each and every citizen to pay their taxes honestly without resorting to subterfuges."

The Court dismissed the appeal without making any findings about whether the appellant had used any dishonest methods to avoid or evade paying taxes. Despite being supported by a strict interpretation of the law, the tax imposed on the company was not upheld due to its finding that it had engaged in questionable practices.

The majority view expressed and the judgment of Justice Ranganath Mishra and other 3 members of the bench after analysing the existing valid provisions of statues, came to the conclusion that, 'duty to pay excise duty was on manufacturer'. According to him, the producer has a "exclusive duty" in paying the excise tax. Even if payment had been made in line with an agreement, it would still have the excise duty character because the buyer's payment only satisfied the manufacturer's obligation. Therefore, the excise paid was to be applied to the manufacturer's total income in order to determine his sales tax burden. The producer was reduced to a mere "colourable device," employed by the him to evade or minimise sales tax through a covert arrangement

[27] *1983 SCC (4) 697.*

that obscured the transaction's true nature while reaping the benefits of said earnings.[28]

'Tax planning is permissible provided it is within the four corners of law but colourable devices are not part of tax planning and such a transaction should be disregarded without giving benefits of such transaction to the assesse. It is wrong to honour the dubious methods of tax avoidance as every person is bound to pay tax without taking recourse to subterfuges.'

Observation of Justice Chinnappa Reddy

The Remarks made by Justice Chinnappa Reddy against evasion and avoidance of taxes are to be noted specially. In this case the company's act amounts to a narrow line separating tax evasion and tax avoidance by reducing the taxes which is legally permitted under law by way of lawful, honest and justifiable means on one side and on other side reducing the tax by way of colourable devices and unaccepted methods on the other side. There is a principle called as the "Westminster" principle which is formulated and adopted by the courts in England by applying this principle in Judicial decisions.[29] But Justice Chinnappa reddy has stated that the immense need to depart from the "Westminster" principle, is that "every man is authorised to reduce the burden of tax imposed upon him in a lawful legitimate manner. This principle was wrongly interpreted and not followed in the correct sense.[30] This has clearly differentiated the difference between the tax evasion and avoidance which describes tax evasion is an offence and tax avoidance is purely permissible. In contravention the courts adopted that "no one can be left free with tax avoidance citing as nothing is illegal". The Court held that

"We are now living in a society and the government's policy is welfare state, its financial needs, have to be respected and met out properly. We must recognise the principle and objectives behind taxation laws and moral sanctions behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation. It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up to the court

[28] Ibid 19.

[29] *Inland Revenue Commissioners v. Duke of Westminster*, [1936] AC 1 (HL), at 19.

[30] *W.T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1981] 1 All ER 865, at 872.

to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and to avoid the devices for what they really are and to refuse to give judicial benediction."[31]

Reddy, J.'s dissenting opinion examines a few English instances to demonstrate the preposition of law pertaining to the avoiding taxes, and the question has been modified even within England. He looked over the IRC V. Duke of Westminster[32], in which this ruling was made:

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow tax-gatherers may be of his ingenuity, he cannot be compelled to pay an increased tax."

"*17*. We think that time has come for us to depart from the *Westminster* principle 1936 AC 1 : 1935 All ER Rep 259 (HL) as emphatically as the British courts have done. In our view, the correct way to interpret a taxing statute, when considering the scope to avoid taxes, the only question arises for consideration is whether the provisions have to be interpreted literally or liberally, even if the transaction is not unreal and not prohibited by the statute, but whether the transaction is a method to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

"*18*. It is neither desirable nor fair to ask the legislature to step in and handle all strategies and procedures that evade taxation. It is the duty of the judiciary to decide the nature and character of the methods adopted to avoid taxes and consider the issues with respect to the existing legislations with new and advanced techniques of interpretation to find out the true character of transaction and if it is done without bonafide purpose then should refuse to give the orders in favour.[33]

He separately in his '*concurring*' decision, held,

'Instead of going into the question of whether transaction is real or not, the real question to be asked is whether transaction is such to avoid tax and if it is such,

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[31] *Ibid 19.*

[32] *1936 AC 1: 1935 ruling. All ER Rep 259 (HL),*

[33] *Ibid 19.*

whether judiciary can accord its approval to such a transaction. The transaction shall have to be looked into as a whole in order to determine its purpose.'

He continued by saying that it was not ideal for the legislature to deal with every questionable tax avoidance strategy. As a result, the judiciary has the authority to decide what kind of technology is used. If the only reason for the transaction was to avoid paying taxes, it ought to simply reject it.

1.2. "Union of India and Anr v. *Azadi Bachao Andolan and Anr"*[34]

The appeals have been preferred in the Apex forum of the country, challenging the Division Bench's impugned judgment of Delhi HC which entertained Writs and a PIL and passed the orders against the respondent UOI and Revenue. The petition was admitted by the High Court subsequently quashed the impugned circular[35] which provides certain instructions by way of clarification to the Chief Commissioners and Director General's of Income tax in the case of the assessees of the Indo-Mauritius DTAA 1983. The main challenge before the Writ Court was that, issuing a direction and orders with regard to the assessment and special classification and treatment towards the assessee are vested with the parliament and the CBDT being a delegated authority which can't perform the role of the principal authority. The circular issued under Sec. 90 and 119 of the I.T. Act, 1961[36] is ultra vires the provisions and to be struck it down. The revenue is appealing this SLP to the Supreme Judiciary, contesting the rulings of the High Court.

Facts

The main facts which was placed before the Supreme Court is that the India being a party to the international conventions with UN and other organisations for the peace and development. The DTAA developed by the OECD and UN is a model draft convention and by adopting the model convention India had entered agreement with the Mauritius with the purpose of preventing financial evasion between the nations and avoiding double taxation. This convention is a bilateral convention and both the parties have agreed to some of the important clauses and

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[34] *(2003) 263 ITR 706 (SC), at 727*

[35] *"Circular No. 789 of 2000, dated 13.04.2000 issued by the CBDT, [2000] 243 ITR (St) 57."*

[36] *Ibid 35.*

proviso in the said convention. This convention was signed on 01.04.1983 and came in to force dated 06.12.1983 and which according to the Art. 28 of the convention a notification was issued by the CBDT by invoking the provisions of the sec. 90 of the Act to provide a clarification by publishing in the official gazette notification and the agreement with India-Mauritius will immediately came in to force. The circular[37] was released by invoking powers u/s. 90 of the Act, stating that the GOI had clarified about the capital gains taxation of the resident and permanent establishment of the Mauritius country will be taxed as per Mauritius law and not in India. With respect to the DTAA and the circular FII Foreign Institutional Investors is to be treated as resident of Mauritius and they have invested a huge capital by purchasing the shares in the Indian Company by making profits with the selling of such shares during their price hikes without tax liability in India.

During the year 2000 the I.T. authorities issued showcase notices to the FIIs functioning in India to give explanation for not being liable for capital gains tax and dividends which they earned in India. The reason stated by the authorities is that, after proper enquiry and investigations about these companies, it is came to be known that all of these companies were shell companies incorporated in Mauritius and operating only for the purpose of investing money in India and by gaining undue advantages of the DTAA and no business operation were taken place in that companies. These shell companies are from the 3rd country where there is no relationship with the 2 countries i.e. India and Mauritius. These companies were not the residents of both the countries to the DTAA and by misusing the term permanent establishment they are claiming the advantages of the DTAA and investing money into India, which will ultimately which will eventually result in a loss of revenue for both governments**.** The show cause notices created fear in the minds of the FIIs and the invested funds were withdrawn and taken back by them, which result in the downfall of economy and the Indian companies either have to winding up or became insolvent and the Indian residents who invested in the companies became panic and the Indian companies were unable to run their operations due to the shot fall of money. Taking all these things in mind the Indian government

[37] *Circular No. 682 dated 30.03.1994 was issued by the CBDT, [1994] 206 ITR (St) 46.*

had issued a press release dated 04.04.2000 stating that the stand taken by the I.T. officials to some of the specific assessment cases did not represent the policy decision made by the Indian government related to the refusal of DTAA benefits.

Later the Board[38] directed to all the Chief Commissioners and Directors regarding the taxation of capital gains and dividend income under Indo-Mauritius DTAA. The provisions of DTAA will apply to all the residents of India and Mauritius. Dividends paid to domestic corporations prior to June 1, 1997, were subject to tax under the I.T. Act of 1961, but now TDS is deductible at 5 or 15 % depending on the shareholding of the resident of Mauritius. For getting these benefits and showing proof of residence, the circular made it clear that a residence certificate from the "Mauritius" government is all that is needed. This certificate is enough to prove residence and ownership of a company for the purposes of the DTAAs.

The said circular No. 789/2000[39] was questioned before the Delhi HC byway of two writ petition by way of PIL. The petitioner in one of the writ petition is Azadi Bachao Andolan seeking for a prayer to quash the circular no. 789 and declare the same as illegal and void which issued by the CBDT.

1) The petitioners pray that the direction may be issued to the UOI to revise, correct or amend the provisions of the Indo-Mauritius DTAA so that NRIs and FIIs does not use the loopholes for their fraudulent gain.
2) To declare and delimit powers of the Indian Union u/s. 90 of the Act with respect to the agreements with foreign countries.
3) To declare and limit the powers of the CBDT with respect of issuing circular, notification or orders in the nature of direction to the appropriate authorities such as the I.T. officials with respect to the methods of assessment and the resident certificate is ultra beyond the Board's authority.
4) To quash the impugned circular issued by the Board as illegal and to consequently quash it.

[38] *Ibid 35.*
[39] *Ibid 35.*

Findings of the High Court of Delhi

The court held that, impugned circular shows that it does not contains any direction as per the sec. 119 of the Act and it is not bind on the Revenue authorities. The CBDT has no powers to issue such instructions as it contravenes the provision of the statue because CBDT was established to administer the tax collection, effective administration and management, so violating the vested duty it issued instructions under the Act. The general rule is that once the delegated body cannot further delegate. The CBDT is a delegated body but the I.T. Act is a parent enactment and only the parliament is vested with such powers to make modification in the laws. As in the case of determination of the residential proof and accepting the residential certificate issued the Mauritius tax authorities, to accept the same and grant tax exemption is to be done by the parliament and not the Board. But the CBDT issued instructions to the assessing officers to accept the residential certificate, is ultimately contrary towards the intention of the parliament and CBDT has no such powers to do so.

The I.T. officials vested with the sanctioned duty to solve the corporate tax avoidance and evasions by lifting the corporate veil by checking and ensuring the actual residence status of the assessee as Mauritius resident or he had paid the taxes either in Mauritius or in India is the duty of the I.T. officials and they also act as a quasi-judicial authorities. The impugned circular takes away or limit the powers of the I.T. authorities quasi-judicial functions issued by the CBDT is contrary to the requirements in the Act, because it instructs the Chief Commissioners and Directors of the I.T. to not to involve in the affairs of the persons having residential certificate.

As far as the residential certificate is concerned there is no conclusiveness of the residential certificate provided by the tax authorities of Mauritius or it is not contemplated in the provisions of the DTAAs or under the I.T. Act. If at all this conclusiveness is proved it has to be provided under any of the legislative enactments including the Act. The duty vested with the authority to prevent the Treaty shopping and pass a proceedings by way of adjudication, but the very circular is itself taking away the proceeding power of the authorities concerned. The corporate entities have misused the loopholes in the DTAAs by availing

the benefits by way of setting up of conduit, base or shell companies across the world. Avoidance of double taxation is to be construed as the payment of taxes in any of the country and it doesn't mean that avoiding taxes in both the country. It is not the objective of the treaty and the parties to the agreement concerned. The court had strongly agreement on the stand taken by the Supreme Court and the guidelines issued in the McDowell case and placed reliance upon the judgment and held that the 'impugn circular' was beyond the provision of the Act and it interferes with the powers and functions of the quasi-judicial functions performed by the officers concerned. So it struck down the impugned circular No.789 of 2000 as ultra vires.

Decision of the Hon'ble Supreme Court

After hearing the learned counsel for the appellant UOI and the respondent Azadi Bachao Andolan and the contentions raised by them and the perused the arguments and submission the court is of the opinion and delivered the following judgment.

The well settled proposition of law is that when there is a special piece of legislation or enactment in a particular subject matter of dispute the special enactment will prevail over the parent enactment or statue. Likewise when there is a specific section in the I.T. Act and the DTAA, the DTAA will supersede over the I.T. Act, so the contentions of the respondents are not valid and the issue is answered in favour of the appellant UOI. The mode of assessment for a particular class of income is clearly mentioned in the DTAA then irrespective of whether the provisions for that assessment is contained in the I.T. Act or not is not a dispute, that DTAA will be in operation. In case no such provision is made available in the DTAA, absence to the contrary the I.T. Act will be prevail over the same.

As far as second contention is concerned placed by the respondents the Delhi High Court and this court is that, it is unacceptable that the circular No. 789 in dispute is at odds with the Act's requirements. The circular is within the scope of the sec.90 of the Act and having a legal effects and binding on all the stake holders. The effect of the circular with respect to the sec.119 of the Act issued by the Board is a binding nature and is to be followed by the subordinates such as the I.T. officials and the assessing officers. By virtue of the impugned circular the powers

vested with the assessing officer is taken away by way of instructions to be followed only in a particular which is a quasi-judicial functioned to be excised by the commissioner of appeals.

The court while dealing with the validity of the impugned circular, stated that the "Board" is entitled to pass the required orders, directions, instructions or clarification to their sub-ordinate officers within the scope and ambit of sec. 119 of the Statute and the Writ forum has not reasoned in striking down the impugned circular. The CBDT had excised its powers within the four corners of the powers vested in the Act and also justified their act with the help of DTAA, so this issue if validity of circular raised by the respondent as ultra vires is unacceptable and ruled favouring the appellant UOI.

The court while dealing with the restraining the assessing officer's powers to excise their quasi-judicial function to lift the corporate veil with relation to the conclusiveness of the residence certificate issued by the Mauritius authorities is not sustained and can only be done by the act of parliament and the plea raised by the respondent is rejected by stating that the respondents had misconceived the sections of the Act. The court analysed the sec.119 of the Act and stated that the powers vested with the Direct Tax Board are wider enough and empowered to provide exemption and relaxing some of the preconditions in the Act are acceptable and the act of the appellant UOI has not violated any of the requirements of the Act and held in favour of the appellant and accordingly this issue is answered in favour of the appellant.

The main issue for filing the writ petition and this present appeal by the respondent is that the impugned circular in no. 682 of 1994, dated 30.03.1994 issued by the CBDT regarding the income earned by the residents of Mauritius with regard to the share transfer from company in India is liable to taxes in Mauritius and tax liability would not arise in India. The court after examining the impugned circular and other related material and held that the issues between 2 provisions of the law is treated as per the earlier law established by the courts. The impugned circular issued by the CBDT is in order to implement the provisions of the DTAA signed by the India. as already pointed in the earlier paras of the judgments it is clear that, when the contrary between the I.T. Act and DTAA, the DTAA being the special enactment will supersede and

override the proviso of the I.T. Act. The court had justified that in the absence of issuance of circular/clarification by the CBDT, then the I.T. officials will spend their valuable time, energy, resources and talent in discharging their official duty in an erroneous way, which will ultimately set aside by the commissioner of appeals in the appeal process. As far as the circular no. 789 is concerned it is merely a guiding rules to be followed in the process of assessment and in way it does not takes away the powers of the assessing officers concerned involving in the assessment. So the court held that the issues raised by the respondent with regard to the validity of the impugned circular is unsustain in law and the findings of the Delhi High Court id hereby set aside and the issue is answered in appellant's favour.

The court while dealing with the question of illegality of the treaty shopping stated that the arguments of the respondents that the companies in offshore have incorporating themselves as a shell companies in Mauritius and availing the treaty benefits between the India-Mauritius and there in no active business operation taken place in these companies, which is ultimately a revenue loss to both the governments. Hence treaty shopping is against law and illegal practice and affects the growth of the economy of the contracting states. But in contra the appellant's counsel made a submission that the intention of the legislators or the parties to the agreements was to exclude the persons of the third state means, they would have made an clause exclusively for the same. From this it is clear that it was not the intention of the parties and person entitle to avail the benefits of the benefits of DTAA is that he must be either the resident of one of the countries i.e. India or Mauritius. With regard to permanent establishment the "effective management place" and control is to be taken in to consideration before granting exemptions to the tax and another condition is that the assessee should be liable to taxes in either of the two countries. By which the assessee is either granted exemption, reduction in taxes or refund whichever is possible in the current situation to the assessing officials. Hence as per the conditions and criteria the question of treaty shopping would not arise and this submission of the appellant is accepted, which is valid and reasonable and taken into consideration.

In result the appeal filed by the appellant UOI is allowed both on facts and in law and disposing the case on merits after hearing all the counsels. The High Court of Delhi's ruling to invalidate the circular is now overturned, and it is established that the "circular no. 789, dated April 13, 2000", remains legal and effective. Hence the appeal is allowed and the Judgment is reversed.

CONCLUSION.

India's judiciary will always be remembered for its interpretative analysis and unique decisions, rendered in Tax matters by adopting the principles of harmonious construction, as it is the national importance concerning taxation and revenue generation towards the country. The decisions delivered by the Hon'ble Apex judiciary in the cases cited supra are like of its kind. After reading this, one may come to the understanding that how the forum had played a highly appreciable role in balancing the fundamental rights of the company on the one hand and interest of the government related to taxes on the other hand. Even now the present position is that various cases filed in the SC for challenging the I.T. notices and etc., but the court with utmost patience spending its valuable time in deciding the cases and stating the settled position of law. This law framed by the SC and HC acts as a binding precedent and acts as a law declare by them.