

## TAX EVASION AND TAX AVOIDANCE: TWO SIDES OF THE SAME COIN?

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*“So give back to Caesar what is Caesar’s and to God what is God’s.”*

*-Matthew 22:21*

### **Introduction**

In the context of the question recounting to avoiding or evading of taxes by the common public, the symposium seems to completely turn round around the trapezium of direct taxes as compared to indirect taxes because of the obvious fact that direct taxes have to be paid directly and willingly by the people unlike in case of indirect taxes where people are taxed on goods and services the moment they avail them. As a result of this, the attention of Indian judiciary has been on developing the law relating to evasion of taxes. At times, judiciary found itself in pandemonium as to how to draw line of differentiation between the concept of tax evasion and the idea of ‘unacceptable’ tax avoidance. On the top of this, it must be mentioned that though the issue of tax ‘evasion’ per say seemed to be quite settled but the idea of tax avoidance over a period of time became a matter of both academic and judicial interest. Consequently, there were a myriad of opinions on the same. The purpose of this paper is to study these opinions and come to an acceptable conclusion and suggest some reforms. Hence in the light of the discussion made above, two research questions have been framed-

- **How has the Indian judiciary drawn lines of distinction between firstly, tax evasion and tax avoidance and secondly, ‘acceptable’ tax avoidance and ‘unacceptable’ tax avoidance?**
- **What change did the Supreme Court’s verdict brought to the existing verdict, if any? If yes, has it solved the dilemmas of the Indian judiciary?**

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The paper tries to bring out that there is a dearth of consensus of the judiciary in India on a proper standardization and categorization of cases which would fall under acceptable and unacceptable tax avoidance. This situation of non-standardization remains to be the same even after the Vodafone judgement. The Vodafone case though made a clarification for both investors and income tax authorities that legitimate tax planning is not a colourable device for unacceptable tax avoidance, but it failed to throw light upon what all kind of transactions would come under legitimate tax planning and unacceptable tax avoidance. It rather, by bringing out a mid way paved way for the judiciary to exercise discretion in the future cases to come an decide form case to case basis whether a particular transaction can be called a legitimate tax planning.

In order to achieve this conclusion, the paper first delves deep into the theoretical underpinnings of the concepts of tax evasion and tax avoidance. In second chapter, the legal positions pre-Vodafone has been explored. The third chapter discusses the post-Vodafone regime and the stance of judiciary. This chapter also throws light on how the lacuna in Indian judiciary's stance in relation to standardizing tax avoidance cases seems to ceaselessly operate even after the Vodafone.

The *scope* of the paper is limited to examining judiciary's stance only. It focuses on regime that existed pre-direct tax code and proposed GAAR by the Ministry of Finance, Government of India and does not cater to legislative measures taken by the Indian government. It examines the persisting uncertainty within the India judiciary in relation to tax avoidance norms. To establish the same, the paper employs the '*doctrinal research*' and '*analytical qualitative methodology*.'

### **Tax evasion and tax avoidance: Theoretical underpinnings**

Tax evasion and tax avoidance are deviations from what is to be brought into being legal, reasonable and just. They occur frequently together.<sup>1</sup> It is common in them that they result in losses in the tax revenue.<sup>2</sup> Otherwise they are different from each other. Tax evasion is associated with defiance of the law: It is a fissure developed due to the taxpayers' real demeanour retiring from what has been promulgated as statutory fiscal law. In contrast, tax

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<sup>1</sup>Bentley, D. (1998): Classifying Taxpayers' Rights. In: Bentley, D. (ed.): Taxpayers' Rights: An International Perspective. Gold Coast: Revenue Law Journal.

<sup>2</sup> Bouckaert, B. - De Geest, G. (eds) (1996-2000): Encyclopaedia of Law & Economics. University of Gent Edward ElgarPubi. Ltd.

avoidance does not follow from the breaking of the law. It is yet the circumvention of law: taxpayers entangled in tax avoidance attack what can be seen as the integrity of law.<sup>3</sup>

Tax evasion is not indistinguishable to the trouncing in the budding revenue that could be collected in the want of tax evasion. If tax collection were more proficient, the tax-payers' behaviour would not remain the same, and so the real economic circumstances for tax collection would also be different.<sup>4</sup> From the standpoint of law and economics at least, tax evasion is in fact a wedge between economic reality and the purely legal construction of statutory tax rates.<sup>5</sup> It is closely connected with the informal economy and associated crimes like fraud, false accounting, money laundering, bribery, etc. <sup>6</sup>Tax avoidance is in attitude punishable, although in many cases it is almost unattainable for the ultimate public authority to bear out what has been observed. Tax minimisation is recurrently the unswerving outcome of the use of tax incentives. It is then rigid to say if the exploitation of incentives can be substantiated in full observance with the tenets of tax law.

All in all, 'tax avoidance' and 'tax evasion' are terms so habitually referred to in economic and business dealings today that they compose a substantial part of our daily conversational language and people in general use these expressions even exclusive of the knowledge of their exact connotation and divergence. Whereas tax avoidance implies a state of affairs in which the taxpayer reduces his tax liability by taking benefit out of the shortcomings and ambiguities in the legal provisions, in the case of tax evasion, facts are calculatingly misinterpreted and the tax liability is understated.<sup>7</sup> Thus, while tax avoidance is considered theoretically perfectly legal and is, at times, referred to as 'tax planning', tax evasion is take to be illegal and, therefore, carries with it the jeopardy of penalties and prosecutions under the tax laws. As such, the black economy comprises the sum total of all the various methods of tax evasion but does not include tax avoidance. <sup>8</sup>Many a times, a distinction is made theoretically between 'acceptable' tax avoidance and 'unacceptable' tax avoidance. The former is categorized as tax planning in some jurisdictions.

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<sup>3</sup> Deák, D. Földes, G. (2002): Form and Substance in Tax Law: Hungary, LXXXVIIa. Cahiers de droit fiscal international.

<sup>4</sup> Franzoni, L.A. (1996-2000): Tax Evasion and Tax Compliance. In: Bouckaert - De Geest (1996-2000).

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Anil kumar Jain, (1987), Tax Avoidance and Tax Evasion: The Indian Case, Modern Asian Studies, Vol. 21, No. 2, pp. 233-255

<sup>8</sup> Ibid.

### **Pre-Vodafone and Indian judiciary**

Indian judiciary has been consistently in consonance and agreement with the OECD guidelines in relation to illegality of tax evasion per say. In simple words, Indian judiciary has consistently recognized that tax evasion is a crime and those who evade or even attempt to evade taxes have to be made criminally liable. It was so because the income tax statute<sup>9</sup> itself was very clear about making every form of tax evasion a crime.<sup>10</sup> But judiciary has always found itself in a kerfuffle when it comes to draw lines of distinction between acceptable tax avoidance which has been conventionally termed as tax planning and unacceptable tax avoidance.

The leading judgement on the tax evasion-avoidance deadlock from where it all began is the UK's celebrated case of the Westminster.<sup>11</sup> Lord Tomlin in the said case very categorically stated that individuals and corporations can restructure their financial arrangements so as to minimise tax liability as far as those arrangements are within the four corners of law.<sup>12</sup> He emphasised the right of an individual to order his affairs as per his whims and fancies as long as it is not illegal. And the same over emphasis became an instrument of misunderstood and repeated abuse of the Westminster principle. The principle laid down in the above case was contrasted in the Ramsay case<sup>13</sup> which laid down the modern principle of tax avoidance. It held that—*“it is task of the court to ascertain legal nature of any transaction to which it is sought to attach a tax or its consequence and if that emerges from a series or combination of transactions intended to operate as such, it is the series or combination which may be regarded.”*<sup>14</sup>

The Indian Supreme Court in the most celebrated case of McDowell<sup>15</sup> went on to frame the most widely accepted and appreciated rule which was nothing but an clarificatory extension to the Ramsay modern principle. Justice Reddy emphatically said in the case-

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<sup>9</sup> The Income Tax Act, 1961.

<sup>10</sup> Tax evasion has always been a criminal offence in India. There are so many provisions relating to prosecution under Chapter XXII of the Income Tax Act, 1961. See Chapter XII of the same Act.

<sup>11</sup> IRC v. Duke of Westminster (1936) AC 1

<sup>12</sup> Ibid.

<sup>13</sup> WT Ramsay v. IRC [1982] AC 300.

<sup>14</sup> Ibid.

<sup>15</sup> McDowell & Co. Ltd v. CTO [1985] 154 ITR 148 (SC)

*"But, surely, it is high time for the judiciary in India too to part its ways from the principle of Westminster and the alluring logic of tax avoidance. We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord approval to it."*<sup>16</sup>

Indian judiciary in the same developed the Doctrine of 'Substance over form'. The judicial doctrine of Substance over form is used to determine the true meaning of a transaction disguised by formalisms that exist solely to alter tax liabilities. In such instances, the substance rather than its form will be given effect. Courts generally respect the form of a transaction but will apply the substance-over-form principles when warranted. The most important Indian case addressing substance-over-form question is without a doubt *McDowell and Co. Ltd. v. Commercial Tax Officer*. The Supreme Court took the view that tax planning was legitimate as long as it was strictly within the four corners of the law and any „colourable“ device or dubious methods to minimise tax incidence were not legally permissible. In *Calcutta Chromotype Ltd. v. Collector of C. Ex., Calcutta*<sup>17</sup> the Hon'ble Supreme Court held that, "Colourable devices, however, cannot be part of tax planning. Dubious methods resorting to artifice or subterfuge to avoid payment of taxes on what really is income can today no longer be applauded and legitimised as a splendid work by a wise man but has to be condemned and punished with severest of penalties".<sup>18</sup>

In this way, the Indian courts have laid down the basic principles underlying the anti-tax avoidance measures. But there still was a dearth of consensus on what would constitute acceptable tax avoidance. Nor there was an indication that tax avoidance should be treated at par with the tax evasion. Neither there was any standardization of tax avoidance scenarios.

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<sup>16</sup> Ibid.

<sup>17</sup> 1998 (99) E.L.T 202(S.C.)

<sup>18</sup> Ibid.



### **Post-Vodafone: Question remains unanswered**

On January 20, 2012, the Supreme Court of India delivered a landmark judgment in *Vodafone International B.V. v. Union of India & Anr.*<sup>19</sup> that the transfer of shares of a company incorporated outside India from a seller resident outside India to a buyer resident outside India is not taxable by the Indian tax authorities even if such transfer indirectly transfers an asset in India.<sup>20</sup> The Supreme Court judgment provides clarity to international investors in structuring a variety of cross-border transactions involving India in a tax efficient manner. The Supreme Court validated legitimate tax structuring to implement transactions which are justified by overall commercial and business rationale. While the tax authorities may try to use some of the imprecise language in the Supreme Court judgment to challenge legitimate tax structures, if parties pay careful attention to overall commercial objectives, corporate formalities, corporate substance and proper documentation governing a transaction, legitimate tax structures should be able to withstand such challenges.<sup>21</sup>

Apart from this, it also made a detailed analysis and revision of the tax avoidance law in India through revisiting the pages of earlier decided celebrated judicial decisions. The Supreme Court in the Vodafone judgement held that the McDowell decision cannot be read to be leading to a conclusion that all tax planning is illegal, illegitimate or impermissible and that there is no conflict between the Supreme Court's judgement in McDowell and Azadi Bachao Case<sup>22</sup>. In the Azadi Bachao case, Supreme Court had observed that "an act which is otherwise legal in law, cannot be treated as non-est merely on the basis of some underlined motive that is resulting in some economic detriment to the national interest."<sup>23</sup> (The Hon'ble court had upheld the legality of a CBDT circular stating that once a company had obtained a tax residence certificate from Mauritius, it would not be taxed in India. Supreme Court considered this as an act of legitimate tax planning and not unacceptable tax avoidance.)

<sup>19</sup> Vodafone International Holdings B.V. v. Union of India & Anr. SLP(C) No. 26529 of 2010, Judgment dated 20 January 2012.

<sup>20</sup> Ibid.

<sup>21</sup> Nandan S. Nelivigi, John T. Lillis, David M. Eisenberg, **Supreme Court of India's Vodafone Judgment: Implications for International Investors**, February 2012; Also available at <http://www.whitecase.com/files/Publication/f028d8f0-ab0d-4aae-9c2c-a01af7306430/Presentation/PublicationAttachment/0b5a9323-c05d-488f-82ee-adc9131938/alert-Vodafone-International-BV-v-Union-India-v2.pdf>

<sup>22</sup> Union of India v. Azadi Bachao Andolan (2003) 263 ITR 706

<sup>23</sup> Ibid.

Some big legal practitioners like Mr. Prashant Bhushan had argued that in the Vodafone case, the Supreme Court had the opportunity to correct the misdemeanour of the McDowell rule made in the Azadi Bachao case. But the Supreme Court in the Vodafone judgement very clearly said that Both McDowell rule and the Azadi's ratio stand at different pedestals and should be distinguished and respected at the same time. This brings out the conclusion that SC through the Vodafone clarified once again that there can be a legitimate tax planning by individuals and companies and they can order their affairs the way they want.

All in all, the Vodafone judgement concerned itself with two primary elements in order to arrive at the final conclusion. It took into consideration the legal substance of the transaction as well as the scope of the transactions intended to be covered by the statute.<sup>24</sup> It brought out the approach of "*purposive textualism*"<sup>25</sup> which has been considered as the mid way approach to be adopted by the courts in order to decide the legal nature of a commercial transaction in the context of ant-avoidance and anti-evasion measures.

### Analysis

It must however be mentioned that Supreme Court although clarified the dilemmas for the judiciary itself as to how to appreciate and differentiate the earlier decisions of McDowell and Azadi Bachao and apply them in purposive context. It also made a clarification that legitimate 'tax planning' is also an option available to the individuals and companies. But then again it did not make an attempt to either differentiate between a legitimate tax planning or acceptable tax avoidance and unacceptable tax avoidance or to even categorize or standardize the cases/situations which would fall under unacceptable tax avoidance scheme. In essence, at one hand if it sorted out with the earlier judicial decisions, on the other it again created a gap of not making a categorization and standardization. On one hand, if it filled one gap, on the other it created one. Hence, all in all, what the Vodafone judgment did was to bring to the fore a guiding approach for the judiciary to deal in future cases to come, leaving again a great amount of discretionary power in the hands of judges to decide on case to case basis.

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<sup>24</sup> Nani Palkhiwala ET AL., The Law and Practice of Income Tax 66 (9<sup>th</sup> Edn., Dinesh Vyas Ed., 2004)

<sup>25</sup> SS. Schumacher, Machiven and Tax Advice: Using Purpose to Deal With Shelters and Promote Legitimate Income Tax Advice, 92 MARQ. L. REV. 33 (2008).

### **Conclusion**

The scope of this paper was to examine the experience of Indian judiciary in dealing with tax avoidance and tax evasion preventive measures. As the discussion made above shows, it can be concluded that uncertainty still persists in relation to what transactions can be grouped under unacceptable tax avoidance scheme. Though, it did leave a room for discretion with judiciary to examine each case through the approach of purposive textualism. Hence the hypothesis is proved.

