Tax Avoidance Jurisprudence In India: Questioning the Traditional Narrative

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Introduction

The debate between tax avoidance and tax evasion is as old as taxation itself.[1] This debate is extremely complicated with different people using different terms to describe different things.[2] While some scholars insist on authority of canons of statutory interpretation[3] to assert that tax avoidance

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1 *See* also Walter J. Blum, "Knetsch v. United States: A Pronouncement on Tax Avoidance" (1961) Sup. Ct. Rev. 135, 135-36.

2 *See* also James T. Carter, "Tax Saving versus Tax Evasion" 20 Va. L. Rev. 307 (1934); Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80; Anil Kumar Jain, "Tax Avoidance and Tax Evasion – The Indian Case" (1987) 21 Modern Asian Studies 233, Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693.

3 The most important judicial authority on the point that is repeatedly cited by all scholars – legal, moral or economic – is the famous US opinion by Judge Learned Hand, the of the Second Circuit, in *Helvering* v. *Gregory*, 69 F 2d 809 (2nd Cir 1934), later affirmed by the US Supreme Court in *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935), where Justice Sutherland (for the Court) held, (at 469), "*The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether*

is legally permissible and it is tax evasion which is illegal[4], others insist that there is no difference between the tax avoidance and tax evasion since both involve taxpayer behavior which is factually similar.[5] The global complexity of this debate can also be gauged by running a simple Westlaw search and going through the facts of some of the western judicial precedents on this point.[6] Similarly, in India as well, the kind of transactions that the courts have to understand are getting increasingly complex.[7] Under pressure to respond adequately to this growing challenge, the legislatures in turn have responded with extremely complex taxation.[8] Any attempt to find a quick fix solution to this problem is bound to result in confusion and failure – may it be on the part of the legislator, the judge, the lawyer or, and most importantly, the scholar.[9]

There is a legal angle (since we are, after all, talking about tax 'laws') to this debate according to which tax avoidance is legal as long as it stays on the right side of the law.[10] There is also an economic angle, where scholars have tried to find and study the economic links between tax laws and taxpayer behavior.[11] There is a moral-philosophical angle that engages with the

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avoid them, by means which the law permits, cannot be doubted." (emphasis added). The most famous English opinion, again repeatedly cited by scholars, is the one delivered by the House of Lords in *Commrs. of Inland Revenue* v. *Duke of Westminster*, 1936 AC 1 (HL).

4 James T. Carter, "Tax Saving versus Tax Evasion" (1934) 20 Va. L. Rev. 307, Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80.

5 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 702.

6 *See* also the incredibly complex transaction that was called into question in *ACM Partnership* v. *Commr. of Internal Revenue*, 157 F 3d 231 (3rd Cir 1998); Marvin A. Chirelstein and Lawrence A. Zelnak, "Tax Shelters and the Search for a Silver Bullet" (2005)105 Colum. L. Rev. 1939, 1944. The transaction designed solely for tax avoidance purposes was so complex that even these two learned professors had to omit the full discussion of facts so that the readers can easily understand what was being done. See also *Inland Revenue Commrs.* v. *Burmah Oil Co. Ltd.*, 1982 SC (HL) 114 and more recently.

7 See *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613 at 634-35. On these two pages the lead opinion by Chief Justice Kapadia reproduces the cross-holdings chart submitted to the court by the appellant taxpayer. A cursory look at this chart will baffle the minds of the most senior of tax practitioners, and it will take careful study to find out which company owns which.

8 David A. Weisbach, "Formalism in the Tax Law" (1999)66 U. Chi. L. Rev. 860.

9 *See* also Marvin A. Chirelstein and Lawrence A. Zelnak, "Tax Shelters and the Search for a Silver Bullet" (2005) 105 Colum. L. Rev. 1939; *see also* David A. Weisbach, "Formalism in the Tax Law" (1999) 66 U. Chi. L. Rev. 860.

10 This body of literature argues that the Courts only interpret the law and a transaction falls into the category that is permitted by the law then the matter ends there and it is for the Legislature to make the law so that certain transactions on which they would like to see the tax law applied are covered within the ambit of the law. For those who subscribe to this school of thought disregard any argument made by the revenue authorities on the grounds of the transaction being against "*The Spirit of The Law*". *See* Carter (n 2) at 82, 83 and 89.

11 *See* also Steven Klepper and Daniel Nagin, "The Anatomy of Tax Evasion" (1989) 5 J. L. Econ. & Org. 1.

question as to whether tax avoidance is morally permissible, notwithstanding legality of the taxpayer behavior.[12] The hidden premise in the work of scholars that examine the legality of tax avoidance is that in this domain of the law, legal standards and moral standards are one and the same. Thus, so long as the tax avoidance activity stays on the right side of the law no moral objection can be raised. Relying on judicial authority, some legal scholars also argue that there is a moral entitlement to legally avoiding taxes.[13] The moral scholars, naturally, don't agree with this proposition and maintain that the standards by which morality of tax avoidance is to be judged exist independent of the legal standards.[14] The legal question is limited to figuring out a workable legal method, judicial or statutory, that can be used to draw a line between tax avoidance and tax evasion.[15] For the economist, there is no real difference between tax avoidance and tax evasion since in both cases the state exchequer does not get the tax revenues,[16] but the moralist calls everything into question and changes the nature of the issue completely.[17] For instance, if there is no moral obligation to pay any taxes at all in the first place, why does it matter whether non-payment of taxation is a result of tax avoidance or tax evasion?[18] The moralist engages with several other complicated questions in that.

A few years back, thiseternal, and now increasingly global, debate between tax avoidance and tax evasion came up for judicial consideration before the Supreme Court of India in the well-known *Vodafone International Holdings BV* v. *Union of India* ('*Vodafone case*').[19] In *Vodafone case*, it was unanimously held that the Indian income tax authorities cannot, under section 9 of the Indian Income Tax Act, 1961 impose income tax on indirect transfers of capital assets situated in India.[20] *Vodafone case* was a special case in the sense that it was a foreign investor who had acquired an Indian company without directly acquiring the shares of that company. However, we may spin the facts of the case, in reality Vodafone Int'l had ended up acquiring

12 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 720. *See* also Robert W. McGee, "Three Views on the Ethics of Tax Evasion" (2006) 67 Journal of Business Ethics 15.

13 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009)43 Creighton L. Rev. 693, 700.

14 *Ibid.*, at 716.

15 James T. Carter, "Tax Saving versus Tax Evasion" (1934) 20 Va. L. Rev. 307, Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80.

16 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 715.

17 Robert W. McGee, "Three Views on the Ethics of Tax Evasion" (2006) 67 Journal of Business Ethics 15.

18 *Ibid.*

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

20 *Ibid.*, at 673.

Hutch India albeit indirectly. Could they have acquired Hutch India by directly purchasing the shares of the Indian company? Of course. But there was no law that prohibited what they did and in the process they ended up saving a whole lot of cash in taxes. Was there a business purpose to this whole arrangement? Certainly. Cross border corporate acquisitions of this kind are usually not the kind of transactions that are entered into only to stick your thumb in the nose of revenue authorities.[21] There was a clear incentive of avoiding tax avoidance behind structuring the transaction the way it was structured.It is highly improbable that the transaction would have been structured the way it was structured, if there were no such incentive. This is what makes this case particularly special to study.

Public and scholarly discussion on this matter had actually started before the appeals were even filed before the Supreme Court in this case,[22] went on as the matter was being argued, and continued long after the unanimous decision of the three judge bench was delivered.[23] To overcome *Vodafone case* effect, the Parliament responded by bringing in a retrospective amendment to the Income Tax Act, 1961.[24] As one would expect this amendment attracted a lot of criticism,[25] but retrospective amendments in tax law in order to overcome judicial decisions given in favour of the taxpayers have

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[21] *See* also Omri Marian, "Home-Country Effects of Corporate Investors" (Unpublished Manuscript dated September 9, 2014 presented at the International Business Law Scholar's Roundtable organized at the Dennis J. Block Center for the Study of International Business Law, Brooklyn Law School, New York City, NY on October 10, 2014 on the panel on "Tax"; on file with author).

[22] Anisha Keyal and Pritika Rai Advani, "The Vodafone Judgment–Wider Concerns of Withholding Tax under Income Tax Act" (2010) 3 NUJS L. Rev. 511; *See also* T.P. Ostwal and Vikram Vijayaraghavan, "Anti-Avoidance Measures" (2010)22 Nat'l L. Sch. India Rev. 59.

[23] *See* also Prashant Bhushan, "Capital Gains, Everyone Else Loses" *The Hindu* (23 February, 2012) <http://www.thehindu.com/opinion/lead/article2920912.ece>, where, as the title would suggest, he criticizes the decision as causing massive loss to the public exchequer and Arvind P. Datar, "Vodafone is a Misunderstood Case" (March 2, 2012) <http://www.thehindu.com/opinion/op-ed/vodafone-is-a-misunderstood-case/article2951103.ece>, where Datar responds to Bhushan's misreading of the decision and explains why the no income tax could possibly be imposed on this transaction by the Indian Revenue authorities. *See also* Prashant Bhushan, "Legitimising Tax Avoidance" *Economic and Political Weekly* XLVII(9) 37.)

[24] Finance Act, 2012 (India), S. 4. This provision amends Income Tax Act, 1961, S. 9 with retrospective effect from April 1, 1962. The relevant part of the Income Tax Act, S. 9, *before* the amendment, provided—

> Income deemed to accrue or arise in India.—(1) The following incomes shall be deemed to accrue or arise in India— (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of Income in India or through the transfer of capital asset situate in India.

This provision has been reproduced in *Vodafone*, Blum, *supra* note 1 at 672.

[25] G. Mahadevan, "Vodafone International Holdings BV – A Critical Review of Pre- and Post- Ruling Impact and Future Course of Action" Business Law International 13 (2)

been heavily criticized in past as well.[26] Serious doubts have been expressed over the constitutional validity of certain crucial clauses of this amendment[27] and whether the Indian Parliament has legislative competence under the Constitution of India to levy capital gains tax on indirect share transfer transactions.[28] In fact, the *Vodafone case* itself ended up becoming an electoral issue in the Parliamentary elections of 2014[29] with a special focus onresolving the international arbitration disputes that arose as a consequence of the retrospective amendment.[30] After taking charge a former Law Minister made public statements to resolve this issue.[31] In all this debate, everything centered more around the retrospective amendment and the consequent loss of investor confidence and foreign direct investment. Though much has been written about *Vodafone case* in India and outside, no attention has been paid either by the legal academia in India, or outside or members of the Bar in India to the question of tax avoidancethat the Supreme Court grappled with in that case.[32] Tax avoidance jurisprudence in India is anyway an area

223-234; Matthew Gilleard, "Retrospective Amendments: The Worrying Trend Which Has Taxpayers Looking over Their Shoulders" International Tax Review 23(8) 30.

26 *See* also Nani A. Palkhivala, *We, The People* (2009) 150-51. Speaking specifically in the context of the right to appeal, Palkhivala observed that retrospective amendments make the right to appeal "illusory". Whereas in India the Parliament plays, and has always played, an interventionist role with respect to tax avoidance disputes, in United States and England, this role has traditionally been left to the judiciary; Jain (*supra* note 2) at 248 noting the fact that, "At times the amendments are made merely to get round an adverse decision of the Supreme Court or a High Court…. The amendments are so frequent that, many a time, the assessing officers themselves are not aware of the latest provisions"; David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth" (2001) 12 Corp. Bus. Tax'n. Monthly 21.

27 V. Niranjan, "Defective Validation Clause: The Impact of the Finance Act, 2012 on Vodafone and Other Assessees" (2012) 5 SCC J-25.

28 Khagesh Gautam, "Taxing Offshore Transactions in India and the Territoriality Clause – The Case for Substantial Constitutional Limitations on Indian Parliament's Power to Retrospectively Amend the Income Tax Act" (2014) 40 International Tax Journal 19.

29 *See* also Gireesh Chandra Prasad, "Will Narendra Modi Make it Less Taxing for Investors, Officials?" *Financial Express* (19 May, 2014) <https://www.financialexpress.com/archive/will-narendra-modi-make-it-less-taxing-for-investors-officials/1252235/>; Uttara Choudhury, "What US Investors Want from Modi: To Kickstart India's Economy" Firstpost (17 May, 2014) <http://www.firstpost.com/world/what-us-investors-want-from-modi-to-kickstart-indias-economy-1529075.html>.

30 Asit Ranjan Mishra and Remya Nair, "The Economic Mess That Narendra Modi Will Have to Unravel" *Livemint* (26 May, 2014) <https://www.livemint.com/Politics/3e4dqcszr0pXsREcKgtl9J/The-economic-mess-that-Modi-will-have-to-unravel.html>; James Crabtree, "Modi Faces Dilemma over Ending India's Tax Fight with Vodafone" *Financial Times* (June 10, 2014) <https://www.ft.com/content/d1eaa8ac-f063-11e3-b112-00144feabdc0>.

31 *See* also "Retrospective Taxes Should be Avoided: Ravi Shankar Prasad" *The Economic Times* (28 May, 2014) https://economictimes.indiatimes.com/news/economy/policy/retrospective-taxes-should-be-avoided-ravi-shankar-prasad/articleshow/35646526.cms?from=mdr.

32 G. Mahadevan, "Vodafone International Holdings BV – A Critical Review of Pre- and Post-Ruling Impact and Future Course of Action" Business Law International 13(2) 223-234;

that has not received any academic attention and very little and only patchy attention by members of the Bar. The objective of this articleis to fill this crucial gap.

This article is divided into two parts.Part 1 addresses itself to one of two gapsidentified above i.e. the lack of academic attention given to tax avoidance jurisprudence in India. The popular narrative in India in this regard is the one that may be deduced from short articles that appear in press and news magazines and on occasion in legal journals. This article contends that the popular narrative presents an inaccurate picture of the tax avoidance jurisprudence in India. Part 1 reconstructs the 'Popular Narrative' and points out its deficiencies. To remedy this in Part 2 examines the 'Actual Position'. The Popular Narrative gives undue weightage to a few Supreme Court opinions, most notably *McDowell & Co. Ltd.* v. *CTO ('McDowell')*[33] consequently creating a biased and incorrect understanding of the law. The only way to remedy this is to study how the understanding of this area of law has evolved in India. The Supreme Court of India was established in 1950. *McDowell* was delivered in 1985. Thus Part 2 divides this 64-year timeline into three zones – the pre *McDowell* era (1950-1984), *McDowell* (1985) and the post *McDowell* era (1985-2014).

An examination of the pre *McDowell* cases discloses two distinct methods of judicial decision making.The first, designated as the 'Interpretational Approach', is the traditional approach where the judges invoke traditional and well accepted principles of statutory interpretation to resolve tax avoidance disputes.[34] These interpretational principles are well accepted canons of statutory construction in Britain and the United States. The second, designated the 'Judicial Test Approach', is where the judges would articulate a judicial test to resolve similar disputes. A judicial test would be articulated in one case that would subsequently be applied in another case without invoking any principles of statutory interpretation. The Judicial Test Approach heavily resembles the judicial decision making methodology of the United States Supreme Court. The predominant method used in the pre *McDowell* era was the Interpretational Approach and it was effectively used to deal

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Prashant Bhushan, "Legitimising Tax Avoidance" *Economic and Political Weekly* XLVII (9) 37. *See also* Geoffrey T. Loomer, "The Vodafone Essar Dispute: Inadequate Tax Principles Create Difficult Choices for India" (2009) 21 Nat'l L. Sch. India Rev. 89.

33 *McDowell & Co. Ltd.* v. *CTO*, (1985) 3 SCC 230.

34 As a footnote, we may note here that the Interpretational Approach heavily resembles the judicial decision-making methodology of the British Courts. A comparative examination of the Indian and British judicial decision making method is beyond the stated scope of this article but wherever necessary equivalents and divergences in the British and the United States judicial decision-making methods have been pointed out either briefly in the text of the paper or by the way of footnotes.

with and satisfactorily decide cases involving a tax avoidance question. Even though growing factual complexity of the cases involving a tax avoidance questions slowly lead the judges of the Supreme Court of India to realize that the Interpretational Approach might not always be the most effective method of resolving tax avoidance disputes, they were always very reluctant to use the Judicial Test Approach. In *McDowell* – a case incorrectly considered in the Popular Narrative as the most important tax avoidance case in India – Justice Reddy wrote a concurring opinion that was completely unaware of the pre *McDowell* position and thus, far satisfactorily used Interpretational Approach. The post *McDowell* period has been living under the shadow of *McDowell* where the primary emphasis has been to dilute the effect of Justice Reddy's concurrence in *McDowell*, which has finally been achieved in *Vodafone Case*, but again in complete ignorance of well-established pre *McDowell* tax avoidance jurisprudence. By examining the legal position in these three time periodsand by comparing and critiquing them on occasion by using foreign cases, Part 1 attempts to discredit the Popular Narrative by presenting the Actual Position that discloses two distinct decision making methodologies that the Supreme Court of India has used while engaging with tax avoidance cases.

Before moving forward, an important procedural point must be highlighted for the reader not familiar with the inner workings on the Supreme Court of India.The Supreme Court of India ordinarily sits in divisions of two judges that under article 145 of the Constitution is called a 'Division Court' but is popularly known as a 'Division Bench'.[35] If in the course of the hearing of any matter before a Division Bench it is felt that the matter must be dealt with by a larger bench, the matter is referred to the Chief Justice who accordingly constitutes a bigger bench, usually consisting of three judges.[36] But, whenever a case involving a substantial question of law as to the interpretation of the Constitution is involved a bench of 5 judges, or more if

[35] Constitution of India, Art. 145– "Subject to the provision of clause (3), rules made under this article may fix the minimum number of Judges who are to sit for any purpose, and may provide for the powers of single Judges and Division Courts". Accordingly, the Supreme Court Rules, 1966, Or. VII R. 1 (relevant part) provides – "... every cause, appeal or matter shall be heard by a Bench consisting of not less than two Judges nominated by the Chief Justice...". The title of Or. VII reads "Constitution of Division Courts and Powers of a Single Judge". There is a list of eight kind of matters, in Or. VII R. 1 that a Single Judge of the Supreme Court can hear and dispose of, an examination of which is not relevant for this article.

[36] Supreme Court Rules, 1966, Or. VII R. 2 – "Where in the course of the hearing of any cause, appeal or other proceedings, the Bench considers that the matter should be dealt with by a larger Bench, it shall refer the matter to the Chief Justice, who shall thereupon constitute such a bench for the hearing of it."

necessary, must necessarily be constituted.[37] Such a bench is popularly called a 'Constitution Bench'. The bigger the bench of the Supreme Court that decides the case, the greater the doctrinal value attached to it.[38] Wherever an Indian Supreme Court decision is discussed in this article, the number of judges that comprised of the bench, and how many concurred and dissented, has been mentioned. If no judge dissented, the bench (after mentioning the number of judges comprising the bench) is referred to as a unanimous bench.

Part 1 – The Popular Narrative

The narrative that is popular in India with regards to tax avoidance versus tax evasion debate is the one that has *McDowell* at its center. As per this narrative, before *McDowell* came and caused substantial turbulence, the position of law was settled in India whereby tax planning was a legitimate activity.[39] The Courts would look at the taxation statutes strictly notwithstanding how much hardship it may cause to the taxpayer or the revenue authorities. The authority cited to support this seemingly settled pre *McDowell* position was *CIT* v. *A. Raman & Co.*[40] Along with it comes

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37 Constitution of India, Art. 145(3) – "The minimum number of Judges who are to sit for the purpose of deciding any case involving a substantial question of law as to the interpretation of this Constitution … shall be five:

> Provided that, where the Court hearing an appeal under any of the provisions of this Chapter other than Article 132 consists of less than five Judges and in the course of the hearing the appeal the Court is satisfied that the appeal involves a substantial question of law as to the interpretation of this Constitution the determination of which is necessary for the disposal of the appeal, such Court shall refer the question for opinion to a Court constituted as required by this clause for the purpose of deciding any case involving such a question and shall on receipt of the opinion dispose of the appeal in conformity with such opinion."

38 *See generally* A. Lakshminath, *Precedent in Indian Law: Judicial Process* (2009)

39 *See e.g.* K. Vijay Kumar, "Tax Avoidance vs. Tax Evasion", TaxOnlineIndia, <https://taxindiaonline.com/RC2/inside2.php3?filename=bnews_detail.php3&newsid=605>; C.P. Ramaswamy, "Tax Planning: Does Westminster's Prevail over McDowell's?", Bombay Chartered Accountants' Society, (April, 2004), <https://www.bcasonline.org/articles/artin.asp?368>.

40 *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49; *see also* Indraneel R. Chaudhury, "From McDowell to Vodafone", *The Hindu BusinessLine* (March 11, 2012), <http://www.thehindubusinessline.com/features/taxation-and-accounts/from-mcdowell-to-vodafone/article2984857.ece>. Chaudhury's piece is perhaps the most clear example of the point being made here where he cites *McDowell* as, "The foremost decision in India on the matter…"; Suresh Surana, "Know the Difference between Tax Planning & Tax Avoidance", *The Economic Times* (September 13, 2011), <https://economictimes.indiatimes.com/wealth/personal-finance-news/know-the-difference-between-tax-planning-tax-avoidance/articleshow/9962651.cms>. Surana's short piece also pays the same adulation to *McDowell* as other pieces cited here; S. Muralidharan, "Now, A Tax Avoidance Threshold", *The Hindu BusinessLine* (July 3, 2010), <http://www.thehindubusinessline.com/todays-paper/tp-opinion/now-a-tax-avoidance-threshold/article997480.ece>; Dipanshu Singhal,

Justice Reddy with his extreme views in the concurring opinion, he delivered, in *McDowell* on the authority of which the Revenue authorities started questioning all legitimate cases of tax planning.[41] Thus, revenue authorities started abusing *McDowell*, while the poor taxpayer got reeled under excessive tax rates, highhandedness and arbitrariness of revenue officials.The Bar, and in some immediate post *McDowell* opinions the Bench, criticized Justice Reddy's extreme views in *McDowell*. Thus, Justice Reddy's extreme views were never considered correct and never totally accepted by the Bar, the Bench and the taxpayers.Relief ultimately came in the *Indo-Mauritius DTAA Case*,[42] and then *Vodafone case*, that struck a decisive death blow to Justice Reddy's extreme views or, to ironically use Justice Reddy's own phrase, finally 'exorcised the ghost' of *McDowell* from the face of Indian tax avoidance jurisprudence.[43]

This narrative is based on an incomplete understanding of the way in which law has evolved in the pre *McDowell* era. In my view, this is a time period which has not been carefully studied within or outside India.Most writings on Indian tax avoidance jurisprudence usually begin with *McDowell*. This is not a sound approach. In order to truly and properly understand what the Supreme Court did right or wrong in *Vodafone* or in *McDowell*, it is necessary tofirst understand how the Court arrived at the decision.[44] *Vodafone* itself seems to have become a particularly important point of contest between tax payers especially multinational corporations, and the Indian income tax

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"Indian GAAR Story", Money Control (November 20, 2012), <http://thefirm.moneycontrol.com/story_page.php?autono=784709>.

41 K. Vijay Kumar, "Tax Avoidance vs. Tax Evasion", TaxOnlineIndia, <https://taxindiaonline.com/RC2/inside2.php3?filename=bnews_detail.php3&newsid=605>. The author of this short internet article, a retired Superintendent of Central Excise, maintains that *McDowell*, especially Justice Reddy's opinion, is a case that, "Any student of taxation should read…" The author takes a mildly critical view of Justice Reddy's opinion though. Most of the short pieces on tax evasion in India are very similar in the narrative they construct to this short piece. They, like this article, begin with *McDowell*.

42 *Union of India* v. *Azadi Bachao Andolan*, (2004) 10 SCC 1.

43 *See also* Indraneel R. Chaudhury, "From McDowell to Vodafone", *The Hindu BusinessLine* (March 11, 2012), <http://www.thehindubusinessline.com/features/taxation-and-accounts/from-mcdowell-to-vodafone/article2984857.ece>. By the end of his short piece Chaudhury observes that the Supreme Court reinstated, "… the Westminster principle [as] the cornerstone of law [such that now] every taxpayer is entitled to arrange his affairs so as to reduce the tax liability."

44 This becomes additionally important in light of the post *Vodafone* tax disputes where the Indian Income Tax authorities have focused their attention on several multi-national corporations and have initiated income tax proceedings against them on the grounds of tax evasion. *See e.g.* Utpal Bhaskar, Remya Nair and Amrit Raj, "Shell India Accused of Tax Evasion", *Livemint* (February 1, 2013), <http://www.livemint.com/Companies/VzRIkNIEGaV3Gbd5MdhdNL/IT-department-alleges-under-pricing-of-15000-cr-by-Shell.html>.

authorities.[45] Filling this gap provides important lessons in understanding how the Court used to deal with tax avoidance issues, where the important lessons of the past were forgotten and how they can be now revived or revisited to deal with these perplexing questions today.[46] With the pressing need to raise more tax revenues the tax authorities are under a consistent pressure to recover more taxes. In situations like this it is seemingly convenient for the tax authorities to slap tax demands on tax payers on the grounds of tax evasion.[47] In these circumstances, it becomes even more important to resuscitate the forgotten lessons. A comparative analysis of these lessons also provides important lessons to foreign jurisdictions, most importantly the United States and Britain, to have a closer look at their own tax avoidance jurisprudence. The Popular Narrative also unfairly chastises revenue authorities for being highhanded and arbitrary in the post *McDowell* period, though in my experienceIndian revenue authorities do sometimes times, or as the Popular Narrative would have it most of the times, act unfairly and uncharitably towards the taxpayers.

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45 *See e.g.* Gangadhar Patil, "DNA Exclusive: Tax Evasion – IBM India told to cough up Rs 5,357 cr", *DNA India* (November 1, 2013), <https://www.dnaindia.com/business/report-dna-exclusive-tax-evasion-ibm-india-told-to-cough-up-rs5357cr-1912053>. This news article reports that IBM India was served an income tax notice on the grounds that, "… IBM India had suppressed revenue to evade tax under the export promotion scheme of the Software Technology Park of India (STPI)."

46 Utpal Bhaskar, Remya Nair and Amrit Raj, "Shell India Accused of Tax Evasion", *Livemint* (February 1, 2013), <http://www.livemint.com/Companies/VzRIkNIEGaV3Gbd5MdhdNL/IT-department-alleges-under-pricing-of-15000-cr-by-Shell.html>. This article in a leading financial newspaper reports that the income tax proceedings against Shell India were initiated, "… in the backdrop of the $ 2 billion tax dispute between Vodafone Group Plc and the Indian tax authorities, though the transactions are of a different nature." That the transactions are of a different nature is an extremely important point to note as demonstrated throughout Part 2 of this article.

47 *See e.g.* Reuters, "Probe into Cadbury India's Rs 200 cr Tax Evasion Case", *Business Standard* (November 23, 2013), <http://www.business-standard.com/article/companies/probe-into-cadbury-india-s-rs-200-cr-tax-evasion-case-112112300080_1.html>, Press Trust of India, "Govt. Initiates Probe into Kraft's Cadbury Takeover", *Business Standard* (January 4, 2011), <http://www.business-standard.com/article/companies/govt-initiates-probe-into-kraft-s-cadbury-takeover-111010400101_1.html>. This probe into the Kraft-Cadbury takeover was, "… for alleged tax evasion and flouting of buyout norms." The probe was clearly motivated by the, "… UK-based Vodafone's arm [that was] asked to pay over Rs 11,000 crore as taxes for buying Hong Kong based Hutchison's telecom company." The Kraft-Cadbury probe interestingly came about as the result of a public interest litigation filed in the Delhi High Court on the ground that, "… while acquiring the shares and assets of Cadbury, Kraft Food Inc. was under an obligation to pay tax on the acquisition of the Indian business." *See also* Bureau, "2 Tax Evasion Cases by Cadbury India Detected: Govt.", *The Hindu BusinessLine*, (November 22, 2012), <http://www.thehindubusinessline.com/companies/2-tax-evasion-cases-by-cadbury-india-detected-govt/article4123721.ece> and Rajesh Kumar Singh, "Govt. Investigating Cadbury India in Tax Evasion Case", Reuters (November 22, 2012), <http://in.reuters.com/article/2012/11/22/cadbury-india-investigation-idINDEE8AL03U20121122>.

The manifest incorrectness of the Popular Narrative is demonstrable. Two identical views expressed by respected members of the Bar may be examined to prove this point. The first of these two was expressed by the legendary tax and constitutional lawyer Nani A. Palkhivala, while critiquing the 1968-69 budget,and the second was by another distinguished member of the Indian Bar, S.P. Gupta, while critiquing the abuse of *McDowell* by revenue authorities in 2003.Criticizing the Revenue authorities' arbitrariness Palkhivala said that, 'The environment and setup are highly conducive to the general tendency to record conclusions adverse to the assessee and let the law take its course – its painfully prolonged and tiring course. The prick of the official conscience is assuaged by the knowledge that the wronged assessee has the right of appeal and reference'.[48] Gupta wrote that as a result of *McDowell*, '… several innocent commercial and financial acts and transactions of the [taxpayers] which were till then neither treated nor supposed to be treated as taxable suddenly found themselves threatened with being dragged within the pale of taxability and even penalization. The observations in [*McDowell*] against tax avoidance have so emboldened the assessing and taxing authorities that it results in a lot of unreasonableness and high-handedness towards the [taxpayers]'.[49] These identical observations made decades apart establish that revenue authorities' highhandedness and arbitrariness was a constant before and after *McDowell*.Therefore, *McDowell* cannot be legitimately invoked to ascribe to the revenue authorities'mischievous conduct which they are being charged with after *McDowell* was delivered in 1985, something that the Popular Narrative strongly, but clearly incorrectly, insists. In fact, Palkhivala, while delivering a memorial lecture in 1965, strongly criticized the tax laws and tax administration in India as 'arbitrary provisions which stem from individual whims' and 'an administration marked by petrification of discretion and paralysis of the will to do justice'.[50] Revenue authorities have been, therefore, doing the same thing before and after *McDowell*. Thus, it makes *McDowell* an extremely insufficient explanation of revenue authorities'alleged mischievous behavior. Thus, thereis need to revisit the original sources, and relevant judicial opinions on the point, in order to create an accurate historical timeline since 1950 so that we may objectively examine what changed and what remained constant in pre and post *McDowell* periods.

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48 Nani A. Palkhivala, *We, The People* 132-33 (2009).

49 S.P. Gupta, "The McDowell Dictum – Vanishing Line between Tax Avoidance and Tax Evasion", (2003) 5 SCC J-15.

50 Nani A. Palkhivala, *We, The People* 97 (2009).

PART 2 – THE ACTUAL POSITION

A. Pre McDowell Position (1950-1984)

In the pre *McDowell* period, as disclosed by a review of the law reports, there are several cases where issues of tax avoidance and tax evasion were raised but not all those cases are important for the purpose of this article.[51] One obvious example is the set of cases that involve outright tax evasion by the reason of fraud.[52] Therefore, only two types of cases were selected for a closer inspection. First is the kind where the true character of the transaction was not disputed. In cases falling in this category, the taxpayer was

[51] See e.g. *A. Thangal Kunju Musaliar* v. *M. Venkatachalam Potti*, AIR 1956 SC 246. This was a unanimous five judge constitution bench opinion where certain references made by the State Government in respect of evasion of taxes where challenged on the ground that the government had no jurisdiction to make those references beyond the specific time periods for which it was empowered under the law. The question of law eventually came down to understanding whether the government had the requisite jurisdiction and to what extent can the High Court go, under Art. 226 of the Constitution, to judicially review such executive actions. The actual transaction by the taxpayer was not something that the Court was concerned with. There are a few other cases like these where certain laws of executive notifications have been challenged as unconstitutional. Cases such as these have been omitted from the discussion because these cases throw no light on what sort of transaction was undertaken by the taxpayer and why the Revenue was characterizing that transaction as tax evasive. In other words, there was no substantial tax evasion question involved in these cases. *See also M. Ct. Muthiah* v. *CIT*, AIR 1956 SC 269, where Taxation on Income (Investigation Commission) Act of 1947 was challenged on the ground that it violated the Equality Clause (Art. 14) of the Constitution. This law provided that the cases of "substantial evaders" of income tax were to be treated by a drastic and summary procedure whereby they could not exercise certain procedural rights like the right to inspect documents and the right to question finding of facts made by the Income Tax Officer in appeal, a right that other persons not falling within that class could enjoy, only because the government was of the view that a certain class of taxpayers fell into the category of "substantial evaders". The unanimous five judge constitution bench ultimately held that the classification was violative of the Equality Clause. But for reasons articulated in context of the previously noted case in this footnote, the case even though touching on the topic of tax evasions is essentially a constitutional matter where the validity of the legislation is in question and not a case where the characterization of a transaction is disputed. Thus this case cannot be included in our discussion of pre *McDowell* cases. See also *CIT* v. *Shanti K. Maheshwari*, 1957 SCC OnLine Bom 116 : AIR 1958 Bom 478 (Bombay High Court), where the question before a division bench of two judges of the Bombay High Court was about interpretation of certain articles of an Indo-Pak Double Taxation Avoidance Agreement; *Baldev Singh* v. *CIT*, AIR 1961 SC 736; *Ghanshyamdas* v. *CST*, AIR 1964 SC 766, for other example of cases that even though touch upon the subject of tax evasion or income/turnover escaping assessment do not qualify to be discussed for the purposes of the current discussion. Other cases that do not quality despite having a discussion on tax evasion in them are noted as and when required during the course of this article.

[52] See e.g. *Jagannath Prasad* v. *State of U.P.*, AIR 1963 SC 416 for cases that fall into this category. This is a case where forged documents and invoices were submitted along with sales tax returns in order to avoid application of sales tax laws. The taxpayer was prosecuted and convicted for tax fraud. The Court speaks about the importance of preventing tax evasion but the context is completely different and thus not relevant for this article.

attempting to obtain the tax benefits that would arise if the transaction was held to be covered by a certain provision of a statute, taxation or otherwise. Second is the kind where true character of the transaction was itself disputed. Here a deduction or an exemption was claimed by the taxpayer while computinghis tax liability that was denied by the revenue authorities on the groundsthat the deduction or the exemption was not genuine, but result of a colorable device.

In the first category, the judges would examine the text of the statute and invoke the aid of the long established principles of statutory interpretation to resolve the dispute. Since the facts of the cases (i.e. the true nature of the transaction) before the Court were not disputed, the question perforce was strictly legal restricted only to an examination of the applicable statute. The traditional judicial way of resolving this dispute, not just in India but in almost all common law jurisdictions, has been to 'interpret' the law for that is a functioneminently within, and has always understood to be within, the domain of the judiciary. In the first category five distinct principles of statutory interpretation stand out clearly in the Indian tax avoidance jurisprudence. These are – (1) The Legislative Intent Rule, (2) The Textual Rule, (3) The Minimum Liability Rule, (4) The Strict Interpretation Rule, and (5) The Restrictive Strict Interpretation Rule. These rules are not mentioned in any order of preference.

In the second category, the true nature of the transaction is itself disputed, thus, making the judicial function a bit more complex. Determination of the true nature of the transaction is necessarily a factual question. This determination cannot be successfully obtained by the application of principles of statutory interpretation, for these principles are rules of constructing a legal text and not of determining facts.[53] Thus, the need to articulate a judicial test, as has been done in other contexts by almost all common law courts, to determine the true nature of the transaction. Once this determination is obtained, there is no restriction for the revenue authorities to raise a question of law i.e. even though true nature of the transaction is now determined (thus, there being no dispute as to the facts), the law is not applicable to this transaction. At this state we find ourselves facing a question that falls in the first category where the question is not of facts but of law. This is where the judge sometimes carries on with the judicial test previously articulated. But,

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[53] *See e.g.* Martin A. Chirelstein, "Learned Hand's Contribution to the Law of Tax Avoidance", 77 Yale. L. J. 440, 441 (1968) where, speaking in context of Justice Hand's contribution, Chirelstein makes a distinction between permissible and impermissible tax avoidance that he says is the basis on which it is to be decided whether a "literal construction" of the statute is appropriate or not. For Chirelstein therefore the invocation of a particular statutory interpretational rule is based on first examining the true nature of the transaction.

it stands to reason that since the traditional method of using statutory interpretation has worked well in the past, the judge ought to continue with that method unless there is a strong reason to do otherwise. In the second category, four distinct judicial tests seem to have been articulated by the Court, but they operate in very narrow areas. These are – (1) The Test of Ordinary Course of Business, (2) The Prudent Businessman Yardstick, (3) The Test of Bonafide Commercial Transaction, and (4) The Test of Commercial Expediency.

I. THE LEGISLATIVE INTENT RULE

One of the earliest cases on point is 1957 3-judge bench opinion delivered in *CIT* v. *Sodra Devi* ('*Sodra Devi*').[54] In this case,this rule was invoked by the Court to interpret the Income Tax Act of 1922 to resolve a tax avoidance dispute.The taxpayers, in these bunch of tax-appeals before the Supreme Court, had admitted to the benefits of their partnership firm obtained with the help of their minor sons and wives.[55] Businessmen had been regularly resorting to this arrangement in British India[56] because there was no provision in the Income Tax Act of 1922 to include the income of wife or a minor child in the computation of the total income of 'any individual' for the purpose of assessment.[57] The absence of any such provision in the Act resulted in a lot of income that escaped assessment.[58] Note here that the Court characterized this arrangement as tax-evasive[59] even though there was no positive provision of law that was being violated. The phrase was used to denote an 'evil' that 'was so rampant' that a positive provision of law was required to remedy it.[60] There was a gap in the law that was being exploited by the taxpayers to bring their taxable income down – a perfectly acceptable legal strategy not just in India but also in other common law jurisdictions. To remedy this problem, in 1937 section 16(3)[61]

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[54] *CIT* v. *Sodra Devi*, AIR 1957 SC 832.

[55] *Ibid*. at 833, 834.

[56] This was a point that was noted by the Income Tax Enquiry Report of 1936. The relevant passages from the Report are quoted *ibid*. at 838.

[57] *CIT* v. *Sodra Devi*, AIR 1957 SC 832, 838.

[58] *Ibid*.

[59] *Ibid*. Justice Bhagwati (for himself and Justice Kapoor) observing that, "There were also cases where husbands and fathers provided shares for their wives and minor sons and thus evaded payment of income tax in regard to their shares in the profits of such partnerships."

[60] *Ibid*. Justice Bhagwati refers to the Income Tax Inquiry Report of 1936 that recommended the insertion of S. 16(3) in order to make taxable the income that was distributed by husbands and fathers to their wives and minor children by entering into nominal partnerships by admitting the same to the benefits of the partnership.

[61] Income Tax Act, 1922, S. 16(3) (relevant part) provided that – "In computing the total income of any individual for the purpose of assessment, there shall be included – (a) so much of the income of a wife or minor child of such individual as arises directly or indirectly: (i)

was inserted into the Act in 1937.[62] But, after insertion of section 16(3) a new problem arose. In this bunch of tax-appeals before the Court, in one of the cases the partner in the firm had admitted his wife and two minor sons to the benefits of the partnership but had subsequently died.[63] As per section 16(3), the partnership income that went to the share of the minor sons was to be included in the income of their father, also a partner in the firm, for computation of income tax. But since he was now dead, section 16(3) could not be used to tax the income that went to the minor sons. So the revenue added the income of the minor sons to the income of their mother who was also a partner in the firm by interpreting the word 'individual' in section 16(3)(a) as including a male as well as a female.[64] Thus, the income distributed to the minors was not allowed to escape assessment, which gave rise to the question as to whether the word 'individual' in section 16(3)(a) was used to mean 'a male of the species' or 'both a male as well as a female of the species'.[65]

Justice Bhagwati found that the use of the word 'individual' in section 16(3)(a) was ambiguous[66] and aid of the Income Tax Enquiry Committee Report of 1936[67] as well as the Statement of Object and Reasons behind the 1937 amendment inserting section 16(3)[68] may validly be taken to interpret the ambiguous word 'individual'.[69] Having examined the background context in which the legislature had chosen the word 'individual' Justice Bhagwati concluded that the word 'individual' was restricted to only to mean 'the male of the species' and not the female[70] even though divorced

from the membership of the wife in a firm or which her husband is a partner; (ii) from the admission of the minor to the benefits of the partnership in a firm of which such individual in is a partner; ..." Another important case that does not qualify for a detailed discussion is the unanimous five judge constitution bench opinion delivered in *Balaji* v. *ITO*, AIR 1962 SC 123 where S. 16(3)(a)(i) was challenged as unconstitutional. The constitutional challenge failed and in that context Justice Subba Rao (for the Court) observed that (at 129), "The object sought to be achieved [by Section 16(3)(a)] was to prevent the prevalent abuse, namely, evasion of tax by an individual doing business under a partnership nominally entered with his wife or minor children.... The mode of taxation may be a little hard on a husband or a father in the case of genuine partnership with wife or minor children, but that is offset, to a large extent, by the beneficent results that flow therefrom to the public, namely, the prevention of evasion of income tax...."

62 *CIT* v. *Sodra Devi*, AIR 1957 SC 832, 838.

63 *Ibid*. at 834.

64 *Ibid*.

65 *Ibid*. at 836.

66 *Ibid*. at 837. Justice Das delivered a dissenting opinion (*ibid*. at 840-846) and held that (*ibid*. at 845), "My conclusion therefore is that there is nothing in the policy of the legislation and the scope and object of the statute which compels one to cut down the natural meaning of the word "individual" used in sub-section (3) of Section 16 of the Act so as to confine it to a male individual alone."

67 *Ibid*. at 838.

68 *Ibid*. at 839.

69 *Ibid*. at 835.

70 *Ibid*. at 839, 840.

from that context it could be interpreted to include both male and female.[71] Consequently it was held, '... it was not the intention of the Legislature to impose additional tax on a mother taxpayer by including in her income the income of her minor children arising from the benefits of partnership of a firm in which the mother and the minors were partners'.[72]

The Court in *Sodra Devi* did not articulate any judicial test to examine the validity of the transaction even though there were some observations regarding the tax evasive nature of the same. This was because the genuineness of the partnership agreement was not disputed by the revenue authorities. This is an important point to note. For a judicial test to be articulated to examine the true nature of the transaction a dispute as to the true nature of the transaction must first exist.If the question is only whether a transaction is being covered by a certain legal provision or not, the nature of the transaction being undisputed, a judicial test is not really required to answer this question because principles of statutory interpretation are sufficient to resolve this dispute.A bare examination of the widely cited US Supreme Court case *Gregory* v. *Helvering*[73] is sufficient to demonstrate this point. This is an important distinction that has not been understood by courts across common law jurisdictions while dealing with tax avoidance disputes. As we will see, the failure to realize this distinction results in courts articulating judicial tests that create more problems than they could solve. These judicial tests, articulated,in fact,to review the true nature of the transaction are subsequently invoked as principles of interpretation to interpret taxation statutes – a purpose for which these tests were neither created nor can legitimately be used. This problem is further compounded by the failure to properly distinguish between a judicial test is to be used and a principle of statutory interpretation. On top of that there is also afurther failure to realize what specific principles of interpretation are to be used on what occasions.

One principle of interpretation that the judgesfeel bound by while interpreting taxation statues is that the terms of a taxing statute cannot be stretched in order to improve upon the efforts of the legislature and to fill gaps left open by the statute.[74] This principle of interpretation has been understood by some judges to mean that a taxation statute in its entirety must be subjected to a strict interpretation, thus, leading to the conclusion that a taxation statute cannot be interpreted by taking assistance of any external aids and must

[71] *Ibid*. at 839.

[72] *Ibid*. at 840.

[73] *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935).

[74] See e.g. *Vestey's Executors* v. *Inland Revenue Commrs*., (1949) 1 All ER 1108 (HL) and *CIT* v. *S. Teja Singh*, AIR 1959 SC 352 (in principle accepting the rule of interpretation laid down in *Vestey's Executors* that the language of the taxing statute cannot be stretched and concluding that on facts it was not applicable).

be interpreted on its text and that too strictly. *Sodra Devi* is an example of (but not the only one)that there is no reason why a taxation statute should not be interpreted using the general principles of statutory interpretation that are available for non-taxation or non-fiscal statues.This is not to mean that all provisions of a taxation statutes can be interpreted using the general principles.But if some parts of a taxation statue can be interpreted using general principles while certain others must be interpreted strictly, the question naturally arises – how are we to separate the provisions of a tax law that can be interpreted using general principles from those that must be interpreted strictly? This question has been answered authoritatively by the Supreme Court as we will later see. Note here that in *Sodra Devi*, the Court not only used the statutory interpretation method to answer the legal question before it, but because the aid of external sources was taken, this case is an authority for the proposition that there is no reason why a taxation statute cannot be interpreted by invoking general principles of statutory interpretation. This rule of interpretation is designated the 'Legislative Intent Rule'.[75] We may caution ourselves by noting that it is not made clear in this case, under what circumstances, and to what parts of a taxation statute isthe Legislative Intent Rule applicable. We may further note that the rule was applied to a machinery provision of the Income Tax Act i.e. a provision pertaining to the computation of the tax liability. A machinery provision may be distinguished from a charging provision i.e. the provision that imposes the charge of the tax or lays down who has to pay the tax and on what basis.

II. THE TEXTUAL RULE

Decided in 1958 by a unanimous bench of 3-judges, *Mazagaon Dock Ltd.* v. *CIT*[76] is the next case that qualifies for a closer inspection.This is a very interesting case on its facts. The taxpayer, a private limited company, incorporated under the Indian Companies Act, was engaged in the business of marine engineers and ship repairers.[77] Its office was in Bombay and for the purpose of the Income-tax Act, 1922, it was ordinarily residing in India.[78] The entire share capital of the appellant was owned by two British companies which were in the business of plying ships for hire.[79] The British companies,

[75] Even in the English common law, it is now well established that the Parliament cannot be expected to anticipate and legislate on every possible method of carrying out a transaction thus the next best solution is to allow the Courts to make assumptions about the legislative intent in certain situations. *See* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 CORP. BUS. TAX'N. MONTHLY 21, 24 (2011).

[76] *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861.

[77] *Ibid.* at 863.

[78] *Ibid.*

[79] *Ibid.*

non-resident in India for tax purposes, had an agreement with the appellant under which their ships were repaired by the appellant at an 'on-cost' basis without charging any profits.[80] The question before the Court was whether the appellant would be chargeable to tax under section 42(2) of the Income-tax Act, 1922?[81] Section 42(1) imposed a charge on income, profits or gains accruing to a non-resident through any *business connection* in the taxable territories.[82]

The appellant made two arguments. The first was that section 42(2) imposed a charge only on a business carried on by a non-resident, and therefore, no tax could be imposed under section 42(2) on the business of the appellant who is a resident.[83] This argument was based on the idea that the true intention behind section 42(2) was to tax the profits of the non-resident but the burden fell on the resident because of its close connection of the non-resident.[84] Rejecting this view it was held, 'The language of the section is clear beyond all reasonable doubt as to what it is that is sought to be taxed under this section. That is only the business of the resident and not that of the non-resident'.[85] The second was that a condition precedent for levy of a charge under section 42(2) was that the non-resident must carry on a business with the resident – a requirement that was not satisfied in this case.[86] This was based on the fact that the business of the non-resident companies was to ply ships for hire with which the appellant has no concern and that of the appellant was to repair ships with which the non-resident companies had no concern.[87] Although smartly crafted, the argument also could not withstand the judicial scrutiny. Rejecting this argument, it was held,

The non-resident Companies send their ships for repair to the appellant, not as they might to any other repairer but under a special agreement that repairs should be done at cost. And further unlike customers who purchased

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80 *Ibid.*

81 *Ibid.* Income Tax Act, 1922, S. 42(2) provided – "Where a person not resident or not ordinarily resident in the taxable territories carries on business with a person resident in the taxable territories, and it appears to the Income Tax Officer that owing to the close connection between such persons the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no profits or less than ordinary profits which might be expected to arise in that business, the profits derived therefrom, or which may reasonably be deemed to have been derived therefrom, shall be chargeable to income tax in the name of the resident person who shall be deemed to be, for all the purposes of this Act, the taxpayer in respect of such income tax."

82 *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861, 867.

83 *Ibid.* at 864.

84 *Ibid.*

85 *Ibid.* at 865.

86 *Ibid.* at 864.

87 *Ibid.* at 866.

goods for their own consumption or use, the non-resident Companies get their ships repaired for use in what is admittedly their business. These are clearly trading activities, organized and continuous in their character and it will be difficult to escape the conclusion that they constitute business.[88]

But most notable is the observation of the Court on section 42(1).[89] In *Anglo-French Textile Co. Ltd*. v. *CIT*[90] the Court, interpreting section 42(2), had held, '…where there is continuity of business relationship between the person in British India who helps to make the profits and the person outside British India who receives or realizes his profits, such relationship constitute a business connection'.[91] Relying on this authority, the Court held that the phrase "where a person not resident in the taxable territories carries on business with a person resident" in section 42(2) should be similarly interpreted.[92]

Note here that the Court did analyze the true nature of the transaction. Now, there was every reason for the Court to lay this down as a judicial test to be applied to similar cases in future. But they didn't because the question before the Court essentially was a legal one – is this transaction covered by section 42(1) or not? Both arguments made by the taxpayer were based on interpretation of section 42(1). Thus, the Court, true to its tradition, followed the statutory interpretation method. We may designate this as the 'Textual Rule'.

As per this rule, the Court examined only the text of the statutory provision to see if the transaction comes within the purview of the same or not. This rule may be distinguished from the Legislative Intent Rule in a very important way. Section 42(1) imposed a charge of income tax on certain types of income and was not concerned with actual computation of the income tax once the income chargeable to tax is determined. Whereas in *Sodra Devi*, the statutory provision was not about determining the charge of the income but about computation of income by adding income of the father and the income of the minor sons who were partners in the same partnership firm. This distinction is crucial to understand where the Legislative Intent Rule is to be invoked and where the Textual Rule is to be invoked. Though *Mazagaon Dock* does not clearly articulate this distinction, it would be made abundantly clear by the Court in a later case when the 'Restrictive Strict Interpretation Rule' would be laid down.

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88 *Ibid*.
89 *Ibid*.
90 *Anglo-French Textile Co. Ltd*. v. *CIT*, AIR 1953 SC 105.
91 Cited with approval at *Mazagaon Dock Ltd*. v. *CIT*, AIR 1958 SC 861, 867.
92 *Mazagaon Dock Ltd*. v. *CIT*, AIR 1958 SC 861, 867.

III. The Minimum Liability Rule

This is the second most important pre *McDowell* rule. It is my view that not just the Supreme Court of India, but all common law courts would be well assisted to keep this rule in their sights anytime they engage with a tax avoidance dispute. This is an established and long accepted ruleof Indian tax avoidance jurisprudence. The rule, the origins whereof can be traced to the British common law, is a well-accepted and long established common law rule of statutory interpretation of taxation and fiscal statutes.[93]

The 1964 case of *CIT* v. *Sivakasi Match Exporting Co.* ('*Sivakasi*')[94] is the first case in point. In this case,there were five firms (one sole proprietorship and four partnership firms) that were engaged in the business of manufacturing matches in *Sivakasi* and the total number of partners in these five firms was 'ten or eleven'.[95] Later, one person from each of these five firms in their representative capacity formed a new partnership to carry on the business of banking and commission-agents for the principal business of marketing the products of different match factories in *Sivakasi*.[96] The new partnership's application for registration with the Income Tax Department as a taxpayer was denied on the ground that different firms could not constitute a valid partnership.[97] After this denial, the partners from these four firms and the sole proprietor came together in their individual capacities, entered into a new partnership for the same purpose and executed a partnership deed.[98] This new partnership was accepted and given a registration certificate as a taxpayer by the Income Tax Officer but the Commissioner of Income Tax, by an order, cancelled the same and directed that the firm be assessed to income tax as an unregistered firm, on the ground that the partnership deed was not genuine and was only to reduce the tax liability of the partners.[99] Before the Supreme Court, it was not disputed that the partnership deed conformed to the legal requirements under the Income Tax Act

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93 *See* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 24 (2011). As per the English common law, "… taxpayers must not be taxed unless they come within the letter of the law. Accordingly, it is the right of all taxpayers to arrange their affairs so as to pay as little as is legally possible…". Though this rule must be read with the cautionary note stuck by the 7th Circuit in *Saviano* v. *Commr. of Internal Revenue*, 765 F 2d 643 (7th Cir 1985) where it was held that a taxpayers in the guise of this principle cannot involve in "financial fantasies" and expect the Revenue to "play along".

94 *CIT* v. *Sivakasi Match Exporting Co.*, AIR 1964 SC 1813.

95 *Ibid.* at 1814.

96 *Ibid.*

97 *Ibid.* at 1814-15.

98 *Ibid.* at 1815.

99 *Ibid.*

as well as the Indian Partnership Act.[100] As it happened, under the Indian Partnership Act there was no legal prohibition against the partners in one firm combining together to form another partnership for carrying on a separate business.[101] The partnership deed therefore was held to be embodying a valid partnership.[102] The objection of the revenue was that if the new partnership is accepted as valid then the profits from the businesses would be split between the new partnership and the already existing previous partnership firms (i.e. between the firms manufacturing the matches and the firms marketing them).[103] The legality of this partnership as permitted by the Indian Partnership Act was not questioned by the revenue authorities. It was the effect of this new partnership that was being questioned and consequently the partnership arrangement was being re-characterized by the revenue as a tax evasive arrangement, even though legally permissible. But the Supreme Court was not impressed and Justice Subba Rao held that, '…the mere fact that one of [the partners] borrowed the capital from a parent firm… or some of [the partners] surrendered their profits to the parent firm cannot make it any the less a genuine firm.'[104] The legal principle at the heart of tax avoidance versus tax evasion debate was noted by Justice Subba Rao as –

> [The partnership agreement] is a genuine document and it complies with the requirements of the law. *It is not an attempt to evade tax, but a legal device to reduce its tax liability.*[105]

Justice Shah in his dissenting opinion also noted this principle (and did not express any disagreement with it) as–

> *It is always open to a person, consistently with the law, to so arrange his affairs that he may reduce his tax liability to the minimum permissible under the law.* The fact that the liability to tax may be reduced by the adoption of an expedient which law permits, is wholly irrelevant in considering the validity of the expedient. But where the law prescribes conditions for obtaining the benefit of reduced liability

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100 *Ibid.* at 1816.

101 *Ibid.*

102 *Ibid.*

103 *Ibid.* The Income Tax Appellate Tribunal had noted that as per the new partnership deed the newly created firm had the right to collect the commission of the entire match production of the larger partnerships whether they effect their sales through the firm or not. Also the fact that most of the capital for the new firm had been contributed by only one member in his individual capacity.

104 *Ibid.* at 1817. Justice Subba Rao (for himself and Justice Sikri) noted that securing capital from another from or surrendering the profits to any other person would not convert a valid partnership into a bogus one. Justice Shah delivered a dissenting opinion (*ibid.* at 1817-21) where he took the view that it was open to the Income Tax Officer to decline to register a partnership firm even if the firm conformed to the provisions of the Indian Partnership Act.

105 *Ibid.* (emphasis added).

> to taxation, those conditions, unless otherwise provided, must be strictly complied with, and if they are not so complied with, the taxing authorities would be bound to refuse to give the taxpayer the benefit claimed.[106]

Both judges did not cite a single judicial precedent in support of the above quoted observations, perhaps because both judges took this principle to be so widely accepted so as to not require any reference to an authority. We may designate this rule as the 'Minimum Liability Rule' whereby if the taxpayer engages in a genuine transaction the consequence of which is the reduction of his tax liability, the Court will not concern itself with the effect of the transaction so long as the transaction is genuine. The 'genuineness' of the transaction is to be judged by testing whether the transaction strictly complies with the relevant law applicable to such transaction. This rule of interpretation is based on the judicial policy that every taxpayer is allowed to so arrange his affairs so as to bring his liability to the minimum permissible under the law.

We began with a distinction between two types of tax avoidance cases. One is where the facts are admitted and only the application of law is contested and second is where the facts are also disputed in addition to the application of law that may or may not be contested. In the first category, the judges have used the principles of statutory interpretation to resolve the legal question and in the second, they use a judicial test to resolve the factual question and then may or may not use principles of statutory interpretation to resolve the factual question. Since *Sivakasi Match Exporting* is a case where the transaction was being re-characterized, it is a factual dispute. A question may fairly be asked – why did the judges not articulate a judicial test in this case? The Court could have articulated a test akin to the 'Business Purpose Test'. The facts were ripe for such an articulation. If the partnership was created only to split the profits thus reducing the taxable income without any business or commercial reason for the firm to exist, revenue authorities would be well within their jurisdiction to say that the firm is nothing but a colorable device to avoid taxes. So why didn't they? Because if we look closely, the facts of this case were not in dispute even though on a first reading it might appear to be so. The Commissioner never argued that the partnership firm as constituted was a device that was not permissible by the law. Lack of business purpose was a plea that the Commissioner never took in this case. Instead the argument was that the net taxable income would be reduced. That, the Court rightly held, is no ground to deny a legally constituted partnership a tax registration certificate. This was because there is no

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[106] *Ibid.* at 1820. (emphasis added)

legal obligation to pay maximum tax that may be levied by the law. There was, therefore, no occasion for the Court to articulate a judicial test and the Court correctly did not venture on to that exercise.

In 1968, a unanimous 3-judge bench of the Court delivered its opinion in *CIT* v. *A. Raman & Co.* ('*Raman*')[107] and re-exposited this principle. *Raman* is the case that, in the Popular Narrative, is understood to be the most important pre *McDowell* case on the point. As is demonstrably the case, it is not the accurate position. *Raman* is also a rather ordinary case. on its facts, that further challenges its position in the Popular Narrative as a case of such high significance as it is made out to be. In this case, the assessment officer had issued notices for reopening assessments for previous three financial years (viz. 1959-60, 1960-61 and 1961-62) to the taxpayer on the ground that an attempt to divert profits to another entity and consequently evade taxation had been made by the partners of the taxpayer.[108] In response the taxpayer raised a plea the assessment officer had no jurisdiction to reopen assessments[109] and in the alternative that correct and proper returns supported by books of accounts for each assessment year had been submitted.[110] After this reply was rejected by the assessment officer, the taxpayer was able to successfully challenge the notices before the Gujarat High Court under article 226 of the Constitution.[111] The Supreme Court granted special leave to the Commissioner of Income Tax,[112] affirmed the High Court's order and dismissed the Commissioner's appeal.[113] The notice for reassessment was issued under section 147(1)(b) of the Income Tax Act, 1961[114] and the 'reason to believe' that income had escaped assessment was a condition precedent to exercise of jurisdiction under section 147(1)(b)[115] failing which the notice of reopening assessment could be quashed.[116] The question before the Supreme Court was, in fact, very narrow – was the exercise of jurisdiction under section 147(1)(b) on assessment officer's part valid in this case?[117] It was in

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[107] *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49.

[108] *Ibid.* at 50-51.

[109] *Ibid.* at 51.

[110] *Ibid.*

[111] *Ibid.*

[112] *Ibid.*

[113] *Ibid.* at 53.

[114] *Ibid.* at 51, relevant part of the Income Tax Act, 1961, S. 147(1)(b) provided – "notwithstanding that there has been no omission or failure as mentioned in Cl. (a) on the part of the taxpayer, the Income Tax Officer has in consequence of information in his possession reason to believe that income chargeable to tax has escaped assessment for any assessment year, he may, subject to the provisions of Sections 148 to 153, assess or re-assess such income or recomputed the loss or the depreciation allowance as the case may be, for the assessment year concerned."

[115] *Ibid.*

[116] *Ibid.*, see also *Calcutta Discount Co. Ltd.* v. *ITO*, AIR 1961 SC 372.

[117] *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49, 52

response to this narrow question that the unanimous three judge bench in this case had made an observation that would subsequently be cited in the Popular Narrative as an authoritative pronouncement on the point.

One of the arguments that the revenue made in order to defend the issuance of notice of reopening assessment was that there was some income that could have been earned by the taxpayer but, in fact, it (owing to the arrangements made by the taxpayer) was not and was instead earned by some other entity.[118] If this arrangement would not have existed, then the income of the taxpayer would have been higher.[119] The arrangement made by the taxpayer was a 'subterfuge' or a 'contrivance' and for this arrangement the income would 'normally' have been earned by the taxpayer.[120] The argument was rejected and it was in this context that the following observation, which is cited in the Popular Narrative, was made –

> *But the law does not oblige a trader to make the maximum profit that he can out of this trading transactions.* Income which accrues to a trader is taxable in his hands: income which he could have, but has not earned is not made taxable as income accrued to him. By adopting a device, if it is made to appear that income which belonged to the taxpayer had been earned by some other person, that income may be brought to tax in the hands in the hands of the taxpayer... *Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented.*[121]

It takes only a moment's reflection and comparison of this view with the view taken in *Sivakasi Match Exporting* Co. in 1964 to see that the principle of law being laid down is exactly similar. *Raman* was subsequently cited with approval by a unanimous 3-judge bench in 1972 in *Lachminarayan Madan Lal* v. *CIT*[122] and in 1973 by a division bench in *CIT* v. *Calcutta Discount Co. Ltd.*[123] Thus, it made the "well-accepted proposition that the

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118 *Ibid.*
119 *Ibid.*
120 *Ibid.* at 52-53.
121 *Ibid.* at 53. (emphasis added)
122 *Lachminarayan Madan Lal* v. *CIT*, (1973) 3 SCC 76.
123 *CIT* v. *Calcutta Discount Co. Ltd.*, (1974) 3 SCC 260. In this case the taxpayer company floated a subsidiary company and transferred to that various shares held by it. In return the subsidiary transferred to the taxpayer company its shares amounting to INR

law does not oblige a trader to make the maximum profit that he can out of his trading transactions" and that "an assessee can so arrange his affairs as to minimize his tax burden" a part of Indian tax avoidance jurisprudence. The observations of the bench, in *Madan Lal*, are worth noting in full –

> Avoidance of tax liability by so arranging commercial affairs that *charge of tax* is distributed is not prohibited. A tax-payer may resort to a device to diver the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality but on the operation of the Income Tax Act. But… if it is made to appear that the income which belonged to the assessee had been earned by some other person, that income may be brought to tax in the hands of the assessee.[124]

IV. The Strict Interpretation Rule

This rule in India has been taken directly from the 1920 British opinion delivered in *Cape Brandy Syndicate* v. *Inland Revenue Commrs.* ('*Cape Brandy*').[125] The following quote from *Cape Brandy* has been cited with approval in several Indian Supreme Court opinions –

13,881,173. The book value of these shares of the subsidiary was INR 16,669.391. The taxpayer company thus suffered a loss of INR 27,02,389 on the transaction but never claimed that loss on its tax returns. However the income tax officer valued these subsidiary shares at their market value and concluded that in fact the taxpayer has made a profit of INR 10,240,546 on the transaction and accordingly imposed income tax on the same. The income tax officer's order was reversed by the Appellate Commissioner; the Appellate Commissioner's order was upheld in appeal by the Income Tax Appellate Tribunal, then by the Calcutta High Court and finally by the Supreme Court. The Calcutta High Court held that in absence of any evidence to show that this was a sham transaction the income tax officer's order cannot be sustained. Relying on *Raman* the Revenue's appeal was dismissed by the Supreme Court and High Court's reasoning was upheld.

124 *Lachminarayan Madan Lal* v. *CIT*, (1973) 3 SCC 76, 81. Though it would be profitable to note that on the facts the taxpayer lost this case. The taxpayer in this case was a firm of three brother partners. Their business was that of manufacture and sale of aluminium utensils. Till a given assessment year, the firm was making sales directly to customers but in the next year the firm claimed that a commission was paid to another firm and claimed deduction in its tax returns. This selling agency, it turned out, was nothing but a "manifestation" of the taxpayer firm created only to minimize taxable income by claimed a "make-believe" deduction. Out of the five members in this selling agency, one partner was also a partner in the taxpayer firm. The other two partners were wives of the partners in the taxpayer firm, two minor sons of the fellow who was partner in both firms and his major son. Besides, and most importantly, the selling firm had not even come into existence on the date on account of the sales for which it had received the commission for which the taxpayer firm had claimed deductions.

125 *Cape Brandy Syndicate* v. *Inland Revenue Commrs.*, (1921) 1 KB 64 .

> In a Taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[126]

Unfortunately in an overwhelmingly large number of these Indian opinions, *Cape Brandy* is indiscriminately used and cited without any attempt by the judges to establish why *Cape Brandy* in that case can be legitimately cited.[127] There are also other opinions, the facts of which need not detain us, where this principle has been recognized by the Court without direct reference to *Cape Brandy*.[128] It is not being suggested that the above quoted principle is not a sound principle of interpretation but a blind reliance on this principle is neither an advisable practice nor a wise one.

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[126] *Ibid*. at 71.

[127] See e.g. *CTO* v. *Binani Cements Ltd*., (2014) 8 SCC 319 : (2014) 68 VST 459, where the issue was the grant of an eligibility certificate for exemption from payment of sales tax; *CIT* v. *Shahzada Nand & Sons*, AIR 1966 SC 1342, where the dispute was regarding issuance of a reassessment notice; *Baidyanath Ayurved Bhawan (P) Ltd*. v. *Excise Commr*., (1971) 1 SCC 4 at 7 where the dispute was regarding levy of excise duties on certain medicinal substances on the ground that they contained alcohol; *ITO* v. *T.S. Devinath Nadar*, AIR 1968 SC 623, where the dispute was regarding the scope of rectification powers given under the Income Tax Act of 1922, speaking for the unanimous 5-judge constitution bench Justice Mitter observed, "[The *Cape Brandy* principle has] been accepted as correct both by the English courts and the superior courts in this country. It is now well established that if the interpretation of a fiscal enactment is in doubt ... the subject cannot be taxed unless he comes within the letter of the law and the argument that he falls within the spirit of the law cannot avail the department." These authorities have been cited by way of illustration. It is completely beyond the scope of the stated objective of this paper to venture into a detailed examination of this particular principle of statutory interpretation thought the author feels obliged to report that a survey of the Indian cases on the point disclose that there are two sides to this principle – (1) a general rule that a charging provision must be strictly interpreted that sometimes is misunderstood by some judges to mean that the entire taxation statute must be strictly interpreted and (2) a specific rule that if any ambiguity remains in the taxation statute an interpretation favoring the taxpayer must be adopted. This second side of this principle provides considerable support to the Minimum Liability Rule according to which the taxpayer has a legal right to legally minimize its tax liability. Both these read together go a long way in establishing that morality of tax avoidance notwithstanding, it has always been accepted in the common law courts that the taxpayer has a right to pay the legal minimum by way of taxes to the State. For a discussion on the morality of tax evasion, *see* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 277 (2009).

[128] See e.g. *CIT* v. *Mir Barkat Ali Khan Bahadur*, (1975) 4 SCC 360; *Lakshmi Kant Jha* v. *CWT*, (1974) 3 SCC 126, 132, Justice Khanna for the Court observing that, "It, no doubt, appears to be somewhat harsh that in computing the value of an asset only the price it would fetch if sold in the open markets has to be taken into account and the expenses which would have to borne in making the sale have to be excluded from consideration. This, however, is a matter essentially for the legislature. No resort can be made to an equitable principle for there is no equity about a tax." The caveat mentioned in *supra* note 127 is applicable here as well. These cases are cited by way of illustration for a more detailed examination of this rule is beyond the stated objective of this article.

It is necessary first therefore to examine the context in which *Cape Brandy* was decided. Three gentlemen, who were members of different firms, came together and formed the Cape Brandy Syndicate.[129] They purchased 3100 casks of brandy from Cape Government[130] and shipped some of this brandy to London where it was blended with French brandy and subsequently sold, for profit, between July 1, 1916 and September 17, 1917.[131] Resisting the application of the excess profits duty, the taxpayers argued that the profits they had earned were the realization of a speculative investment and not profits arising from a trade or business carried on by the appellants.[132] In any case the business did not commence until 1916 and excess profits duty could not be charged on a business commencing after August, 1914.[133] Justice Rowlatt found that the charge of tax was created on, '...the amount by which profits made since the outbreak of war have exceeded what is called the pre-war standard of profits'.[134] But if company had commenced business, "... after the outbreak of war there has, of course, been no pre-war trade year".[135] Describing the revenue authorities' attempts to levy the pre-war standards on the business of the taxpayers that was commenced after the war as 'extremely artificial' and 'too wide and fanciful' he held,

> ... in a taxing Act one has to look merely at what is clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[136]

This was, thus, in the context of a charging provision that Justice Rowlatt made these observations.

Now, note what happened afterwards. The British Parliament had enacted another statute by which the excess profits duty was extended to a post-war period,[137] thus, imposing 'not in direct words but by necessity, this tax on trade and businesses commencing after August 4, 1914'.[138] Staying true to the principle of strict interpretation he held,

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129 *Cape Brandy Syndicate* v. *Inland Revenue Commrs.*, (1921) 1 KB 64.
130 *Ibid.*
131 *Ibid.* at 65.
132 *Ibid.*
133 *Ibid.* at 65, 66.
134 *Ibid.* at 69.
135 *Ibid.* at 70.
136 *Ibid.* at 71. On this basis it was held that by Justice Rowlatt that, "I find it quite impossible to hold that this tax has been imposed by the Finance (No. 2) Act, 1915, upon a person who had no pre-war trade or business."
137 *Ibid.*
138 *Ibid.* at 72.

> I have come to the conclusion that s. 45, sub-s. (2), of the Act of 1916 extends the scope of the Act of 1915. I must treat this exposition in the Act of 1916 in the same way as if it had been given by a Court binding upon me, compelling me to construe the Act of 1915 in a way that I could not otherwise have done... the only effect I can give to the legislation is to say that the interpretation of the Act of 1915 given by the Act of 1916 must ensure for the purposes of construing similar Acts, although not containing the same words as the Act of 1916.[139]

What the judge had held in context of the charging provision of the 1915 Act, because of the charge being extended by the 1916 Act, by the application of the same principle the judge had to hold all over again. In other words, upon a strict interpretation of the charging provision of the 1915 Act the taxpayers were not liable but since the charge was extended to post-war years by the 1916 Act, by the application of the exact same principle the taxpayers were liable and were held to be so. The taxpayers argued that the 1916 Act only laid down a rate of tax and not a charge but this argument was summarily rejected by the judge.[140] A careful observer will instantly note that *Cape Brandy* was a case that was not even close to either a tax evasion or a tax avoidance case. There was nothing of the sort even remotely hinted in this case. This was a case that involved a purely technical question of law and other than an ardent student or a practitioner of taxation laws, or perhaps a brandy connoisseur, the case would hardly interest the general public.

The rule is also stated in *Tarulata Shyam* v. *CIT*[141] (and affirmed by a unanimous 5-judge constitution bench in *Janapada Sabha, Chhindwara* v. *Central Provinces Syndicate Ltd.*[142]) where the unanimous three judge bench, speaking in context of sections 2(6A)(e), 12(1B) and 23A of the Income Tax Act of 1922, the interpretational principle was stated as follows –

> ... in a taxing act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used. Once it is shown that the assessee comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be.[143]

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[139] *Ibid.*
[140] *Ibid.*
[141] *Tarulata Shyam* v. *CIT*, (1977) 3 SCC 305.
[142] *Janapada Sabha, Chhindwara* v. *Central Provinces Syndicate Ltd.*, (1970) 1 SCC 509, 514.
[143] *Ibid.* at 316 (internal citations omitted). See also *CIT* v. *Central India Industries Ltd.*, (1972) 3 SCC 311, where a division bench of the Supreme Court, in context of the provisions in the Income Tax Act of 1922 that were inserted in order to check evasion of income

V. The Restrictive Strict Interpretation Rule

This is the most important rule of interpretation articulated by the Supreme Court that goes a long way in resolving tax avoidance disputes. Looked at in isolation, one cannot help but wonder that at the marvelous genius of this seemingly uncomplicated rule that opens up the paths considered heretofore closed primarily because of a misunderstanding of the scope of the Strict Interpretation Rule. But looked on a broader timeline, one realizes that this rule is nothing but a refined and more evolved version of the Legislative Intent Rule and the Minimum Liability Rule read together. This rule also gives a deep insight into resolving tax avoidance disputes to all members of the legal profession across common law jurisdictions. This rule seems to have been completely forgotten in India and the sooner this rule is revived the better.

This rule was first laid down in, what I considerthe most important pre *McDowell* opinion,by a 3-judge bench in *Murarilal Mahabir Prasad* v. *B.R. Vad*.[144] Despite this decision being of such great significance, it has not been cited in either *McDowell* or any of the post *McDowell* opinions. In this case, a partnership firm, doing business in Bombay, was registered as a 'dealer' under the Bombay Sales Tax Act of 1953 and then the Bombay Sales Tax Act of 1959.[145] A 'dealer' is a taxpayer under the Indian sales tax statues. For certain assessment years (1957-58), the sales tax officer assessed that the taxpayer firm had suppressed sales worth INR 41,47,090 that had escaped assessment.[146] During the period in which the assessment proceedings were pending, it was brought to the attention of the sales tax officer that the firm was actually dissolved in 1962.[147] This raised a question that had a jurisprudential angle to it as well. The question was that whether the sales tax officer had the authority to reassess a taxpayer firm that had ceased to exist prior to the date the assessment order was passed.[148] The reason behind the

tax by dividends being distributed in form of equity, observed that, "Equitable considerations are not relevant in interpreting the provisions of a taxing statute...". The Court was not impressed with the taxpayer invoking equity in case where factually it was clear that a clear attempt to evade payment of income tax by circumventing the law was being made. The Income Tax Appellate Tribunal had held that distribution of shares was not a distribution of profits and thus their value cannot be considered as divided. On appeal, the Supreme Court reversed and held when dividend in received in kind (in this case in form of shares), the market value of those shares can be added to the income of the taxpayer on which income tax can be levied for otherwise, "... companies may distribute their dividends in kind and under-value the goods distributed and thereby facilitate evasion of tax by their share-holders."

[144] *Murarilal Mahabir Prasad* v. *B.R. Vad*, (1975) 2 SCC 736.

[145] *Ibid*. at 739.

[146] *Ibid*. at 740.

[147] *Ibid*. at 741.

[148] *Ibid*.

question being that was nothing in the law that expressly authorized the revenue authorities to assess a dissolved firm, therefore, making everything done by the sales tax officer without the authority of law.[149] Also, if there was no firm that survived, to whom would assessment notices be served?[150] The, now dissolved, taxpayer firm naturally invoked the interpretational principle that while interpreting fiscal statutes one must have regard only to the letter of the law and not the spirit of the law.[151] If accepted, this would allow the taxpayers firms to evade their tax liability by dissolving their firms before the assessment orders were passed.[152] Justice Chandrachud, speaking for the majority, resolved this question in a way that is a great example of judicial craftsmanship[153] and his words are worth reproduction in full and a very careful study –

> The true implication of the principle that a taxing statute must be construed strictly is often misunderstood and the principle is unjustifiably extended beyond the legitimate field of its operation. Indeed, the more well-expressed the principle in *Cape Brandy case*… the greater the reluctance to see its limitations… **There is no equity about a tax in the sense that a provision by which a tax is imposed has to be construed strictly, regardless of the hardship that such a construction may cause either to the treasury or the taxpayer.** If the subject falls squarely within the letter of law he must be taxed, howsoever inequitable the consequences may appear to the judicial mind. If the revenue authorities seeking to tax cannot bring the subject within the letter of law, the subject is free no matter that such a construction may cause serious prejudice to the revenue authorities. **In other words, though what is called equitable construction may be admissible in relation to other statutes or other provisions of a taxing statute, such a construction is not admissible in the interpretation of a charging or taxing provision of a taxing statute… To put in other words, the subject is not to be taxed unless the charging provision clearly imposes the obligation.**[154]

149 *Ibid*. at 742.

150 *Ibid*. at 747.

151 *Ibid*. at 748. The Court also noted that the principle, coming from the English opinion *Cape Brandy Syndicate* v. *Inland Revenue Commrs*., (1921) 2 KB 403 that "In a taxing statute one has to look at what is clearly said. There is no room for intendment. There is no equity about a tax." was a part of Indian tax jurisprudence as well.

152 *Ibid*. at 745, 746.

153 The dissenting opinion was delivered by Justice Gupta that, in the opinion of this author, failed to realize the distinction between a "charging provision" and a "machinery provision" as correctly made by Justice Chandrachud. The distinction, it is submitted, is based on sound jurisprudential foundations and on a true reading of the observations as made by Justice Rowlatt in *Cape Brandy*.

154 *Murarilal Mahabir Prasad* v. *B.R. Vad*, (1975) 2 SCC 736, 749. The English common law equivalent of this rule has been described, in David Dunbar, "Tax Avoidance: A Judicial

Thus, by clarifying the scope of the Strict Interpretation Rule, Justice Chandrachud cleared the way for using ordinary principles of interpretation, one of which is the Legislative Intent Rule, to interpret the non-charging provisions of a taxing statute. It would be noted that not one of the cases discussed in this paper raised a dispute about whether or not the taxpayer was covered by the charging provision. In other words, in not one case was the taxpayer's stand that the charging provision is not applicable to it. The disputes are mostly centering around the question as to whether the taxpayer, by particular transaction, is permitted to take the tax benefits. Or whether a particular deducting or exemption claimed by the taxpayer on his returns may legitimately be claimed under the taxing statute. The provisions of the taxing statute, thus, subjected to interpretation were not charging provisions – these provisions did not *impose* the tax. They were machinery provision – pertaining to the calculation of tax liability.

Another rule that might offer valuable assistance to the Restrictive Strict Interpretation Rule is stated, for instance, in *State of T.N.* v. *M.K. Kandaswami*.[155] In this case, dealing with a question arising out of a provision of the Madras General Sales Tax Act of 1959, a unanimous three judge bench stated the interpretational principle as follows –

> In interpreting [a provision whose main object is to prevent evasion of tax] a construction which would defeat its purpose and, in effect, obliterate it from the statute book should be eschewed. If more than one construction is possible, that which preserves its workability, and efficacy is to be preferred to the one which would render it otiose or sterile. The view taken by the High Court is repugnant to this cardinal cannon of interpretation.[156]

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or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 27 (2011), as the rule on "purposive construction". The rule is distinguished from the United States Economic Substance Doctrine, first laid down in *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935), to the extent that, "A U.K. court would look at the purpose of the exemption from tax and not assume that it is to allow shareholders to adjust their shareholding without triggering a tax liability whenever it is commercially expedient to do so." Dunbar, after reviewing the views of four commonwealth superior courts viz. United Kingdom, Canada, New Zealand and Australia, concluded that, "The single greatest lesson that Congress and the Supreme Court could take from the British Commonwealth experience is that **all four superior courts have reached the position of accepting that revenue statutes are just like any other statute and should be consistently interpreted in a purpose fashion, having regard to the statutory language and also the intended legislative effect.**" (emphasis added). To these four superior courts, we may now confidently add the Supreme Court of India.

155 *State of T.N.* v. *M.K. Kandaswami*, (1975) 4 SCC 745.

156 *Ibid*. at 751.

It may be noted that this interpretational principle is a derivative of constitutional law. In constitutional interpretation, the rule that 'if two constructions of a law are equally possible and of them leads to the law being constitutionally invalid, while the other one upholds its validity, the law should be read in the manner that upholds its validity' is well recognized and established. The above quoted interpretational principle is a derivate of this general rule for the only thing that is different between the above quoted rule of interpreting a taxation statute and the above cited general principle of constitutional interpretation is the phrase 'tax law' against 'a law'.

VI. The Test of Ordinary Course of Business

Contrary to the impression given by the Popular Narrative, *McDowell* is not the only 5-judge constitution bench opinion that dealt with the question of tax evasion, though it should be fairly stated that *McDowell* is the one that factually comes closest to the issue and, most importantly, is the only one in which direct and pointed observations of the sort made in that case. There are two pre *McDowell* 5-judge constitution bench opinions that partly dealt with the question of tax evasion by use of colorable devices by the taxpayers and the attempts made by the Parliament to arrest this problem.

The first was delivered in 1964 in *Navnit Lal C. Javeri* v. *K.K. Sen* ('*Javeri*').[157] In *Javeri*, constitutional validity of section 12(1B) and section 2(6A)(e) of the Income Tax Act of 1922 was challenged.[158] The combined effect of these two provisions was that three types of payments made by a company to its shareholders were treated as dividends to the extent of the accumulated profits held by that company. These three were – (i) payments made to the shareholder by way of advance or loan, (ii) payments made on his behalf, and (iii) payments made for his individual benefit. These legal provisions were enacted because the Parliament had realized that 'though enough money was reasonably available with the company in the form of profits, those in charge of the company deliberately refused to distribute it as dividends to the shareholders, but *adopted the device of advancing the said*

[157] *Navnit Lal C. Javeri* v. *K.K. Sen*, AIR 1965 SC 1375.

[158] *Ibid.*, at 1378. Income Tax Act, 1922, S. 12(1-B) (relevant part) provided that – "any payment by a company to a shareholder by way of advance or loan which would have been treated as a dividend within the meaning of cl. (*e*) of sub-s. (6-A) of S. 2 in any previous year relevant to any assessment year prior to the assessment year ending on the 31st day of March, 1956, had that clause been in force that year, shall be treated as a dividend received by him in the previous year relevant to the assessment year ending on the 31st day of March, 1956, if such loan or advance remained outstanding on the first day of such previous year."

accumulated profits by way of loan or advance to one of its shareholders' with the objective of evading payment of taxes on accumulated profits.[159] The Court was also aware that such colourable devices are employed not just in India but worldwide.[160] However, the government had also realized that these legal provisions would also end up causing genuine hardship for all the genuine transactions of loans.[161] In fact, this was one of the primary grounds on which the constitutional validity of these provisions was assailed.[162] But the Central Board of Revenue issued a circular pointing out to the assessment officers that these provisions should not be applied to genuine transactions and directing them to 'intimate to all companies that if loans were repaid before June 30, 1956 in a genuine manner, they would not be taken into account in determining the tax liability of the shareholders' to whom the loans were advanced.[163] One of the five conditions that must be satisfied for these provisions to apply, as laid down by the majority opinion delivered by Chief Justice Gajendragadkar[164], was that, "...the loan must not have been advanced by the company in the *ordinary course of its business*."[165] In the Chief Justice's view, since the objective behind these provisions was to arrest the evasion of income tax by giving the dividend to the shareholders in the *disguised* form of loan, such a transaction would be covered by these provisions only when it is clear that the company 'does not *normally* deal in money lending'.[166] In so interpreting section 12(1B), he upheld its constitutional validity.[167] The sole dissenting judge, Justice Dayal, however, was not

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[159] *Ibid.*, at 1381.

[160] *Ibid.*, at 1382.

[161] *Ibid.*, at 1379.

[162] *Ibid.*, at 1382. The counsel for the petitioner-appellant had argued that the, "... omission of Parliament to exclude from the operation of S. 12(1-B) genuine loans and advances made as device shows, that it has acted blindly and must, therefore, be held to have exceeded its legislative power..." This argument was obviously rejected.

[163] *Ibid.*

[164] *Ibid.*, at 1377-83, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar).

[165] *Ibid.*, at 1379. (emphasis added). The other four conditions were – (*i*) the company in question must be one in which the public are not sufficiently interested; (*ii*) the borrower must be a shareholder at the date when the loan was advanced, the extent of his shareholding being irrelevant,; (*iii*) the loan advanced could be deemed to a dividend only to the extent to which it is shown that the company possessed accumulated profits; and (*iv*) the loan must have remained outstanding at the commencement of the shareholder's previous year in relation to the Assessment Year 1955-56.

[166] *Ibid.*, at 1381, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar) observing that, "It will be remembered that an advance or loan made by a company which falls within the mischief of the impugned section is advance or loan made by a company which does not normally deal in money lending, and it is made in full knowledge of the provisions contained in the impugned section."

[167] *Ibid.*, at 1382-83, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar) holding that, "If the legislature thinks that the advances or loans are in almost every case the result of a device, it would be competent to it to prescribe

impressed by these arguments[168] and declared these provisions unconstitutional[169] on the ground, *inter alia*, that these provisions imposed unreasonable restrictions on the fundamental right to hold property.[170] The second was delivered, in 1965, in *Punjab Distilling Industries Ltd.* v. *CIT*[171]. The same arrangement made by the Income Tax Act of 1922 to arrest the evasion of income tax by distributing accumulated profits and loans and not dividend was challenged once again in this case except this time the focus was on section 2(6A)(d).[172] The validity of this provision was unanimously upheld[173] and the use of colourable devices to evade payment of income tax and the efforts on the part of the Parliament to arrest this problem were noted once again.[174]

Chief Justice Gajendragadkar's opinion in *Javeri* gives the first but only slight indication of the use of a judicial test in place of a principles of statutory interpretation. Since loans given by the companies to its own shareholders was a disguised form of distributing dividends to avoid income tax, such a practice was to be discouraged. But again, what if the loans were genuine? To overcome this approach, the judge could have invoked the 'Legislative Intent Rule' that was a part of the Indian tax avoidance jurisprudence. It would have been a perfectly acceptable solution on the part of the judge to say that since only the abusive sort of loans were hit by the law, genuine

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a fiction and hold that in cases of such advances or loans, tax should be recovered, from the shareholder on the basis that he has received the dividend."

168 *Ibid.*, at 1383-87.

169 *Ibid.*, at 1387.

170 *Ibid.*, at 1385, Justice Dayal (dissenting) holding that, "It appears to me unreasonable that a particular shareholder who receives a loan or advance from a company be deemed to have received that entire amount as dividend when his proportionate share be much less. I would, for this reason also, consider the provisions of the impugned sections to amount to imposing unreasonable restrictions on the fundamental right to hold property under Art. 19(1)(*f*)." Art. 19(1)(*f*) was repealed by the 44th Amendment in 1978 and now exists not as a fundamental right but only a constitution right under Art. 300-A of the Indian Constitution.

171 *Punjab Distilling Industries Ltd.* v. *CIT*, AIR 1965 SC 1862.

172 *Ibid.*, at 1864. Income Tax Act, 1922, S. 2(6-A)(*d*) provided that, " 'Dividend' includes any distribution by a company on the reduction of its capital to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not."

173 *Ibid.*, at 1868.

174 *Ibid.*, at 1866, Justice Subba Rao (for himself, Justice Mudholkar and Justice Ramaswami, Justice Dayal and Bachawat concurring) observed that, "... a company may, on the pretext of reducing its capital, utilise its accumulated profits to pay back to the shareholders the whole or part of the paid up amounts on the shares. A shareholder though in form gets back the whole or a part of the capital contributed to him, in effect get gets a share of the accumulated profits which, if a straightforward course was followed, he should have received as dividend. This is a division of profits under the guise of division of capital; a distribution of profits under the colour of reduction of capital."

loans were not to be governed by the same. But the next obvious question is – how do we distinguish between genuine loans from the fake ones? One would realize, as is being argued, that principles of statutory construction are not really very helpful to answer this question because of the inherent factual nature of the question. This is perhaps why the judge articulated the test of 'Ordinary Course of Business' whereby if the company that advanced the load was in the business of giving loans to people, and there being no principle that a loan cannot be advanced to its own shareholders, a straight forward application of the anti-tax-avoidance rule in the Income Tax Act would end up causing considerable hardship for genuine debtors of the company for now they not only have to pay the interest on the loan to the company but also pay income tax on the loan that has been deemed to be their income. The shareholders could now continue to get loans from the corporations in which they were shareholders except now they would not be able to get away with abusing anti-avoidance methods i.e. distribution of dividends disguised as loans. However, the Court's use of the phrase 'tax evasion' in this context must be understood as 'tax avoidance' for there is no possible way in which these transactions of loan could be said to be violative of the law.[175]

VII. The Prudent Businessman Yardstick

Perhaps the most important case arising out of the Parliament's efforts to catch the evasion of taxes by use of colourable devices is a 1965 unanimous three Judge bench opinion delivered in *CIT* v. *Gangadhar Banerjee and Co. (P) Ltd.* ("*Banerjee*").[176] This is the second case, that a review of the law reports disclosed, where the Court seems to have diverged, though again only very slightly, from its traditional practice of using principles of statutory interpretation when tax evasion questions are raised. The question that arose in this case was in context of section 23A of the Income Tax Act of 1922[177] that was also introduced to prevent the use of corporations by their members

175 The confusion here again stems out of the use of the terms "tax evasion" and "tax avoidance" and post McDowell the phrase "tax planning" to mean different things. Different parties use these phrases to denote different things but there is no single universally accepted definition. *See e.g.*, David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 22 (2011) where he defined "tax evasion" as, "… [involving] wilful or intentional fraudulent conduct and is a criminal offence. The conduct that gives rise to tax evasion is inherently illegal. That is the main distinguishing feature between tax evasion and tax avoidance that can be defined as involving a legal activity, but one that is not effective for tax purposes. In case of tax avoidance there is no suggestion of fraudulent or deceptive behaviour."

176 *CIT* v. *Gangadhar Banerjee and Co. (P) Ltd.*, AIR 1965 SC 1977.

177 *Ibid.*, at 1978-79.

to 'evade higher taxation'.[178] As per this provision, the assessment officer had to first see whether the dividends distributed by the corporation during the prescribed period was less than the statutory percentage (which was fixed at 60% of the assessable income of the corporation minus the amount of income-tax and super-tax payable by such corporation in respect thereof). If such were the case, the officer was empowered to make an order declaring that the undistributed portion of the assessable income minus the taxes be deemed to have been distributed to the shareholders. But before making this order, the officer was also required to satisfy himself about the reasonability of a larger declared dividend after considering the losses incurred by the corporation in previous years. In other words, just because the declared dividend was small, itis not enough to pass the order. The smallness of the dividend could have been the result of losses incurred in previous years. So before an order under section 23A could be made, previous year losses were also required to be considered. Now the question was that how should the order passed by assessment officer be judicially reviewed?[179]

Clearly this is a question that could be answered in two ways. The Court could either lay down a judicial test to which all the orders should conform and on the basis of which the legality of an order could be tested.Else, the Court could review the order by invoking the 'Legislative Intent Rule', except in the second case. Clarity will emerge only slowly after a few cases have been decided and a judicial trend can be deduced from those cases. There are clear costs and benefits to either of these approaches. In *Banerjee*, the Court decided to adopt the first method that resulted in the 'prudent businessman yardstick'[180] by which section 23A orders were to be reviewed. As per this judicial test, 'The reasonability or the unreasonability of the amount distributed as dividends in judged by business considerations, such as previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others'.[181] The officer was required to put himself in the shoes of a 'prudent businessman' or the 'director of the company' before he makes an order under section 23A. But, the Court also said that it was 'neither possible nor advisable' to lay down any decisive tests for the guidance of the officer.[182]

Javeri and *Banerjee* show that the traditional method of using the principles of statutory interpretation has its limits. There arise certain situations, as disclosed by the facts of these two cases, where the only way to answer the

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178 *Ibid.*, at 1979.
179 *Ibid.*, at 1979-80.
180 *Ibid.*, at 1980.
181 *Ibid.*
182 *Ibid.*

legal question is to lay down a judicial test. The risk of course is that the test might work fine for the case at hand but might not for the next case. This is perhaps why the Court in *Banerjee* left some elbow room for the officer by laying down only general guidelines that he must follow while applying the 'Prudent Businessman Yardstick'.

VIII. The Test of Bonafide Commercial Transaction

In 1966, a dispute similar to *Sivakasi Match Exporting Co.* arose in *M.C.T.M. Chidambaram Chettiar* v. *CIT*[183] that was decided by a unanimous bench of three judges. The facts of this case are very interesting. A Hindu Undivided Family (HUF) was carrying on the business of money lending in British India, Burma and elsewhere.[184] Till assessment year 1927-28, the entity was assessed to tax as a HUF. But in 1928-29, a partition had taken place and the father, with his two sons, constituted a duly registered partnership 'Firm' which was being assessed to tax.[185] In 1929, the father died and was replaced by his wife but the Firm continued.[186] In June 1929, the Firm started a new money lending business at Kuala Lumpur in the Federated Malaya States the capital for which, it was transferred from its business in Burma.[187] In March 1934, 'M. Ct. M. Banking Corporation' ('the Corporation') was launched, which was incorporated in India in a place called Pudukkotai.[188] One of the purposes of the Corporation was to acquire and carry on the Kuala Lumpur money lending business that was previously being carried on by the Firm.[189] The head office of the Firm was in Madras.[190] Therefore, in September 1933, a branch of the Company was opened in Kuala Lumpur and in November 1933, assets of the Firm (net value INR 1,200,000) were transferred to the Company, which in turn allotted to the partners of the Firm 1,200 shares of face-value INR 1,000 each.[191] Despite its incorporation in 1932, the Corporation never declared any dividends.[192] Till December 1937, a profit of INR 504,084 had accumulated to the Corporation and in 1938, it distributed bonus shares of value INR 500,000. On December 31, 1938, out of total of 2,271 shares, the two sons and their mother held 1,944 shares.[193] For assessment year 1938-39, the Firm was treated as the agent of

[183] *M.C.T.M. Chidambaram Chettiar* v. *CIT*, AIR 1966 SC 1453.
[184] *Ibid.*, at 1454.
[185] *Ibid.*
[186] *Ibid.*
[187] *Ibid.*
[188] *Ibid.*
[189] *Ibid.*
[190] *Ibid.*, at 1455.
[191] *Ibid.*, at 1454.
[192] *Ibid.*
[193] *Ibid.*

the Corporation and its income arising and accruing in British India was assessed at the hands of the Firm.[194] For assessment-years 1939-40, 1940-41 and 1941-42, the partners of the Firm were also assessed separately under section 44D of the Income-tax Act, 1922.[195]

The purpose of section 44D was to prevent the residents of India from evading the payment of income tax by transferring their assets to non-residents while enjoying the income by adopting devious methods.[196] Therefore, under section 44D, if a resident had the power to enjoy the income accruing or arising out of the assets transferred to a non-resident, he would be deemed to have received that income and, therefore, would be liable to be assessed under the Income-tax Act.[197]

Resisting the application of section 44D, the taxpayers argued that the phrase 'by means of a transfer' in that section means a transfer by the taxpayer.[198] In this case, the income of the Corporation could not be taxed at their hands because the Firm as a juristic entity was separate from the individual assesses.[199] But the unanimous three judge bench rejected this argument and held that the phrase 'by means of a transfer' means 'as a result or by virtue or in consequence of the transfer'.[200] The Court also observed that that facts, in this case, overwhelmingly established that the individual assesses has a controlling interest in the Corporation.[201] The taxpayer argued that the transfer of assets of the Firm to the Corporation was not for a tax avoidance purpose but rather was a *bona fide commercial transaction*.[202] Though the Court was not completely impressed by this new approach, this argument was not totally rejected either as the Court held that burden of proof to establish the same was on the individual taxpayers and in which they had failed.[203] Thus,

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194 *Ibid*., at 1455.

195 Income Tax Act, 1922 (India), S. 44-D provided: — "Where any person has, by any means of a transfer of assets, by virtue or in consequence whereof, either alone or in conjunction with associated operations, any income which if it were the income of such person would be chargeable to income tax becomes payable to a person not resident or to a person resident but not ordinarily resident in the taxable territories, acquired any rights by virtue or in consequences of which he has within the meaning of this section power to enjoy such income, whether forthwith or in the future, that income shall, whether it would or would not have been chargeable to income tax apart from provisions of this section, be deemed to be income of such first mentioned person for all purposes of this Act."

196 *M.C.T.M. Chidambaram Chettiar* v. *CIT*, AIR 1966 SC 1453, 1455.

197 *Ibid*.

198 *Ibid*.

199 *Ibid*.

200 *Ibid*., at 1456.

201 *Ibid*., at 1457.

202 *Ibid*.

203 *Ibid*.

by saying that burden to establish the *bona fides* of the commercial transaction was on the taxpayer the judicial test option was kept open by the Court.

Next year in 1967, a similar dispute was decided by a unanimous three judge bench of the Court in *CIT* v. *Sri Meenakshi Mills Ltd.*.[204] This case gives a hint of a judicial test akin to the Economic Substance Test as well as a new dimension to the tax evasion cases now coming to the Court. This case is an instance of tax havens that existed in British India, how they were put to good use to evade taxes by businessmen of those days and how the revenue authorities battled with the use of colourable devices to evade taxes. Factually, the nature of this case could be said to be closest to the dispute in *Vodafone case*. In this case, there were three respondent-taxpayers all of which were public limited companies engaged in manufacture and sale of yarn.[205] They all also had branches at a place called Pudukottai.[206] They all used to deposit their sale proceeds at the Pudukottai branch of the Madurai Bank ('the Bank').[207] As it happened, all three of these companies had also borrowed money from the Madurai branch of the Bank on the security of the fixed deposits that were made at the Pudukottai branch and the loans that were granted were far in excess of the available profits at Pudukottai.[208] The interesting thing to note is that out of a total of its 15,000 shares, the bank had issued 14,766 out of which the first respondent Meenakshi Mills held 5,972 shares, the second respondent Rajendra Mills held 3,009 shares and the third respondent Saroja Mills held 4,177 shares.[209] The Income-tax Officer in charge of assessing the tax concluded that, '...the borrowings in British India on the security of the fixed deposits made at Pudukottai amounted to constructive remittances of the profits by the branches of the taxpayer-companies to their Head Offices in India...'[210] and went on to include the entire profits of the taxpayer-companies including the interest receipts from the Pudukottai branches in the assessment of the taxpayer-companies on the ground that overdrafts availed of by the taxpayer-companies far exceeded the available profits.[211]Against this, taxpayers filed an appeal before the appellate Assistant Commissioner, who dismissed the appeal and took the view, '...the Pudukottai branch of the Bank had transmitted the funds so

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204 *CIT* v. *Sri Meenakshi Mills Ltd.*, AIR 1967 SC 819.

205 *Ibid.*

206 *Ibid.*, We many profitably note here that Pudukottai is the same geographical location that was the Corporation in *Chettiar* was located. The extent to which Pudukottai contributed as a tax haven in British India is an extremely interesting historical question that needs to be examined but doing so is beyond the stated brief of this paper.

207 *Ibid.*, 819-20.

208 *Ibid.*, at 820.

209 *Ibid.*

210 *Ibid.*

211 *Ibid.*

deposited for enabling the Madurai branch to advance loans at interest to the taxpayer-companies and that the transmissions of funds were made with the knowledge of the taxpayer-companies who were major share-holders of the Bank'.[212] From this, a further appeal was taken to the Income Tax Appellate Tribunal (ITAT), which the taxpayers lost, with ITAT making scathing remarks against the taxpayer. The ITAT observed, '...Pudukottai is neither a cotton producing area not has a market for cotton; except that it was a non-taxable territory, there was nothing else to recommend the carrying on of the business in cotton spinning and weaving there... being a non-taxable area, there were many very rich men there with an influx of funds to invest in banks and industries... the bank itself was started at Madurai and a branch of it was opened at Pudukottai only with a view to help the financial operations [of the three respondents]'.[213] The taxpayers then took the matter to the High Court of Madras on reference where they won for the first time.[214] The High Court held that it was not established that there was any arrangement between the taxpayer-companies and the Bank whether at Pudukottai or at Madurai for transference of money from Pudukottai branch to Madurai.[215] In other words, the High Court held that no collusion to evade taxes by use of a colourable device was proved. The Commissioner, on appeal, took the matter to the Supreme Court where a unanimous three judge bench of the Supreme Court reversed the High Court.[216]

Before the Supreme Court, the Commissioner invoked section 42 of the Income-tax Act, 1922.[217] As per this provision, if any money was lent at interest outside the taxable territory, any income, profit or gain had arisen or accrued as a result of such being lend at interest and the money was brought back into the taxable territory in cash or kind, then such income was deemed to income arising or accruing within taxable territory. The validity of section 42 on the grounds of it having extra-territorial operation had previously been upheld by the Federal Court of India (the predecessor to the Supreme Court of India) in *A.H. Wadia* v. *CIT* ("*Wadia*")[218] on the ground that the nexus between the income and the authority to tax the same was created by the knowledge, attributed to the lender, that the borrower had borrowed money for the purpose of taking it to British India and earning money on

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[212] *Ibid*.

[213] *Ibid*., at 820-21.

[214] *Ibid*., at 821.

[215] *Ibid*.

[216] *Ibid*., at 823.

[217] Income Tax Act, 1922 (India), S. 42 provided (relevant part only) —"All income, profits or gains accruing or arising whether directly or indirectly ... through or from any money lent at interest and brought into the taxable territories in cash or in kind ... shall be deemed to be income accruing or arising within the taxable territories...."

[218] *A.H. Wadia* v. *CIT*, 1948 SCC OnLine FC 8 : AIR 1949 FC 18.

that income.[219] It was held that the *Wadia* test was satisfied in this case.[220] Expanding on the *Wadia* test it was held in this case that –

> *It is well established that in a matter of this description the Income-tax authorities are entitled to pierce the veil of corporate entity and to look at the reality of the transaction.* It is true that from the juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. *But in certain exceptional circumstances the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade.*[221]

IX. The Test of 'Commercial Expediency'

In a distinctly identifiable line of pre *McDowell* cases, the Court started with the judicial test approach and laid down 'Test of Commercial Expediency' that was consistently used in subsequent cases of similar nature. This line of cases gives considerable weight to the point that there are, in fact, certain categories of tax avoidance cases where the principles of statutory interpretation are not really helpful and that the Court is well aware of this phenomenon. All these cases are factually similar in that a particular transaction is being characterized by the revenue authorities as bogus (and thus, tax-evasive) and by the taxpayer as genuine (and thus, only tax-avoiding). These transactions are those in which a particular expense incurred by the taxpayer is being disallowed by the revenue authorities which the tax-payer

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219 *CIT* v. *Sri Meenakshi Mills Ltd.*, AIR 1967 SC 819, 821.

220 *Ibid.*, at 822.

221 *Ibid.* (emphasis added). Two English cases were cited to support this proposition of law. First was *Apthorpe* v. *Peter Schoenhofen Brewing Co. Ltd.*, (1899) 4 TC 41 (Court of Appeal) (*ibid.*, at 822-23) where it was found that all property of a New York company, except its land, was transferred to an English company. The only reason why the New York company was kept because aliens were not allowed to hold land under New York law. All but three shares of the New York company were held by the English company. Commissioner concluded that the New York company was merely the agent of the English company. The Court of Appeal held that New York business was in fact of the English company and the same was liable for English income tax. The other was *Firestone Tyre and Rubber Co.* v. *Llewellin*, (1957) 1 WLR 464 (*ibid.*, at 823) where an American company had an arrangement with its distributors in Europe whereby they obtained their supplies from the English manufacturer (which was a wholly owned subsidiary of the American company). It was held in this case that in substance the English company was nothing but a means for the American company to carry on its European business (through the agency of its English subsidiary). See also *Kamalpat* v. *CIT*, AIR 1969 SC 932, where a unanimous three-Judge Bench held that lifting of corporate veil is permissible if the corporation is being used for tax evasion or circumventing tax obligation or perpetuating a fraud.

is legally entitled to claim under the Income Tax Act. But even in this category of cases, not all are relevant for this article.[222] The test was laid down, as disclosed by a review of the law reports, for the first time in 1967 by a unanimous three judge bench in *CIT* v. *Walchand & Co. (P) Ltd.*[223] In this case, the taxpayer was a private corporation that had increased the remuneration of its directors and the assessment officer had decided to disallow the increased remuneration of the directors in the computation of income that was filed along with the returns[224] on the grounds that the increase in remuneration was not necessary for the purpose of the sort of business the corporation was in.[225] The Supreme Court allowed the expenses.[226] It was in this context the following test was laid down –

> ... it is not the function of the [assessment officer] to determine the remuneration which in their view should be paid to an employee of the assessee. When a claim for allowance is made... the Income-tax authorities have to decide whether the expenditure claimed as an allowance was incurred voluntarily and on grounds of commercial expediency. In applying the test of commercial expediency for determining whether the expenditure was *wholly and exclusively laid out for the purpose of business*, reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not of the Revenue.[227]

The Commercial Expediency Test was followed by another unanimous three judge bench in 1968 in *J.K. Woolen Manufacturers* v. *CIT*[228] where certain benefits-in-kind and parts of remuneration given to its General Manager

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[222] See e.g., *Shew Kissan Bhattar* v. *CIT*, (1973) 4 SCC 115, where the individual taxpayer had claimed certain interest payments as deductions. The interest payments were compounded because the taxpayer had failed to pay interest on time thus attracting a clause in his loan agreement that compounded the interest in case of failure to pay on time. The compounded interest payments were disallowed and only it was held that the taxpayer is entitled to deduct only the simple interest that he would have originally ended up paying and not the compounded interest the he actually ended up paying. The Court expressed its concerns that if they hold otherwise, "... then to door will be open for evasion of tax. All that the debtor need do is not to pay interest regularly but utilise that amount for other purposes and make the Revenue pay compound interest payable by him and thus derive advantage out of his own omission."

[223] *CIT* v. *Walchand & Co. (P) Ltd.*, AIR 1967 SC 1435.

[224] *Ibid.*, at 1436.

[225] *Ibid.*, at 1436-37.

[226] *Ibid.*, at 1437.

[227] *Ibid.* (emphasis added). The assessment officer had disallowed the increased remuneration because there was no corresponding increase in the profits of the taxpayer corporation. Applying the Test of Commercial Expediency, the Court held that, "The rule that increased remuneration can only be justified if there be corresponding increase in the profits of the employer is, in our judgment, erroneous."

[228] *J.K. Woolen Manufacturers* v. *CIT*, AIR 1969 SC 609.

by the taxpayer corporation were disallowed by the assessment officer on the ground that they were "excessive and quite unreasonable".[229] Applying the Commercial Expediency Test,[230] the Court allowed the expenses as the Court found that the remuneration paid to the General Manager was "... an amount laid out or expended *wholly and exclusively for the purpose of business* of the assessee".[231] It was followed once again in 1972 by another unanimous three judge bench in *Aluminium Corpn. of India Ltd.* v. *CIT*,[232] where certain commissions paid by the taxpayer corporation and claimed as expenditure were found to be *wholly or exclusively for the purpose of the business* of the assessee.[233]

A. McDowell (1985)

McDowell was a short opinion taking only 25 pages in the law report Supreme Court Cases.[234] The reason why the five judge bench was assembled in *McDowell* was to answer a question of law that wasn't all that extraordinary, unless of course you are an ardent student of the law of excise taxes. We'll have to go through the majority opinion by Justice Ranganath Misra that dealt with the legal question that arose on facts on the case, and took 12 pages to answer, to understand this point.[235] The short question before the five judge bench was on a very technical point of excise duty that would hardly interest the general public

> ...whether excise duty paid directly to the excise authorities or deposited directly in the State Exchequer, in respect of Indian liquor, by the buyers before removing the same from the distillery could be said to form part of the taxable turnover of the appellant distillery.[236]

In the end, the question was answered in favour of the revenue authorities but that entire discussion is not relevant to this article. After having clearly answered this question of law in favour of revenue,[237] and having overruled its previous applicable holding on the point (with which Justice Chinnappa

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229 *Ibid.*, at 610.

230 *Ibid.*, at 612. *Walchand* is the only cases cited in support of the Commercial Expediency Test.

231 *Ibid.*

232 *Aluminium Corpn. of India Ltd.* v. *CIT*, (1972) 4 SCC 37.

233 *Ibid.*, at 42.

234 *McDowell* v. *CTO*, (1985) 3 SCC 230-255.

235 *Ibid.*, at 243-255.

236 *Ibid.*, at 244.

237 *Ibid.*, at 250. Justice Misra (for the Chief Justice, Justices Desai, Venkataramiah and himself) holding that, "We are, therefore, clearly of the opinion that excise duty though paid by the purchaser to meet the liability of the appellant, is a part of the consideration for the sale and is includible in the turnover of the appellant.")

Reddy concurred 'entirely'[238]),[239] there was nothing else left to decide in the case. It was, at this point of time, in his opinion that Justice Misra then went on to note the last argument made by the taxpayer, which was – '*...it is open to everyone to so arrange his affairs as to reduce the brunt of taxation of to the minimum and such a process does not constitute tax evasion; nor does it carry any ignominy*'.[240] After discussing four precedents of its own,[241] and one of Gujarat High Court's[242] (that was subsequently affirmed by the Supreme Court[243]) and two English precedents,[244] Justice Misra held as follows –

> Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.[245]

After having held so, he observed that, "*On this aspect* one of us, Chinnappa Reddy, J., has proposed a separate and detailed opinion, *with which we agree*".[246] Thereafter, Justice Misra proceeded to dispose of the petition and grant the relief that was prayed for.

Justice Reddy, opened his concurring opinion by stating that he 'entirely agreed' with Justice Misra, but wished to add a few paragraphs on the topic of tax avoidance.[247] Relying on *Fisher's Executors* and *Westminster* he stated the principles of law that have been demonstrated before as rules of

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[238] *Ibid*., at 233 (emphasis added). In the very first sentence of his concurring opinion, Justice Reddy said that he "entirely agreed" with Justice Misra's opinion.

[239] *Ibid*., at 252. Justice Misra (for the Chief Justice, Justices Desai, Venkataramiah and himself) holding that, "We are of the view that the conclusion reached in the appellant's case in *McDowell & Co. Ltd. case* on the second aspect of the matter, namely, when the excise duty does not go into the common till of the taxpayer and it does not become a part of the circulating capital, it does not become a part of the circulating capital, it does not constitute turnover, is not the decisive test for determining whether such duty would constitute turnover." (Internal citations omitted). The previous decision that was overruled had, as we have seen, the same title as the current case but it was delivered by a Bench of two Judges. *See McDowell & Co. Ltd.* v. *CTO*, (1977) 1 SCC 441.

[240] *Ibid*., at 253.

[241] *CIT* v. *A. Raman & Co*., AIR 1968 SC 49, *CIT* v. *B.M. Kharwar*, AIR 1969 SC 812, *Jiyajeerao Cotton Mills Ltd*. v. *CIT*, AIR 1959 SC 270.

[242] *CIT* v. *Sakarlal Balabhai*, 1968 SCC OnLine Guj 62 : (1968) 69 ITR 186.

[243] *CIT* v. *Vadilal Lallubhai*, (1973) 3 SCC 17.

[244] *Bank of Chettinad Ltd*. v. *CIT*, 1940 SCC OnLine PC 29 : (1940) 8 ITR 522, *Latilla* v. *Inland Revenue Commr*., 1943 AC 377 : (1941-43) 25 TC 107.

[245] *McDowell and Co. Ltd*. v. *CTO*, (1985) 3 SCC 230, 254-55.

[246] *Ibid*. (emphasis added)

[247] *Ibid*., at 233.

statutory interpretation namely the Strict Interpretation Textualism Ruleand the Minimum Liability Rule.[248] After discussing several British cases on the point, he concluded that *Westminster* rule i.e. the 'Minimum Liability Rule' is no longer good law in Britain itself.[249] Citing *Raman* as the case that institutionalized the *Westminster* rule in India, he argued that since *Westminster* has been abandoned in Britain, it is time for the rule to be abandoned in India as well.[250]After making some *obiter* observations about the 'evil consequences of tax avoidance',[251] Justice Reddy did nothing more than laying down a principle of statutory interpretation for taxing statutes in following words –

> 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 its approval to it... 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 to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of 'emerging' techniques of interpretation...* and to expose the devices for what they really are and to refuse to give judicial benediction.[252]

The above quoted passage will subsequently be cited by revenue authorities to say that all kinds of tax avoidance have been held in *McDowell* to be impermissible. In other words, the 'Minimum Liability Rule' is no longer a part of Indian tax avoidance jurisprudence. Though if we read this passage carefully, we can deduce that Justice Reddy is clearly not talking about all kinds of tax avoidance schemes but only those *devices* that cannot be judicially approved. The idea behind Justice Reddy's views were perhaps best expressed by a United States court (7th Circuit) opinion delivered ironically in the same year (1985). In *Saviano* v. *Commr. of Internal Revenue*,[253] the 7th Circuit observed that the freedom to the taxpayer to arrange their affairs so as to minimize their tax liability does not include the right to engage in

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248 *Ibid.*, at 233-34.

249 *Ibid.*, at 234-41.

250 *Ibid.*, at 241-43. He cites *Raman* and *CIT* v. *B.M. Kharwar*, AIR 1969 SC 812, as the two cases where the "Minimum Liability Rule" was institutionalised relying primarily on *Westminster*.

251 *Ibid.*, at 242-43.

252 *Ibid.*, at 243. (emphasis added).

253 *Saviano* v. *Commr. of Internal Revenue*, 765 F 2d 643 (7th Cir 1985).

'financial fantasies' and to expect that the government will 'play along'.[254] In such cases, the Courts will look beyond the contrived forms of transactions. Whereas tax evasion has been defined by several commentators to be restricted to only illegal and/or fraudulent conduct, tax avoidance has been defined to 'involve arrangements that seek to take advantage of the absence of any such evident intention in the words used in the statute'.[255] If this is the case, then the Restrictive Strict Interpretation Rule read with the Legislative Intent Rule is perfectly legitimate guide for interpreting taxation statutes.

One can only speculate what the *McDowell* bench might have done, if the existence of these rules were brought to their attention. Though it is one of the viable conclusions that Justice Reddy might not have taken the extreme view that he took wherein he ended up equating legitimate tax planning, which is a part of Indian tax avoidance jurisprudence as per the Minimum Liability Rule, with abusive tax avoidance that but for the presence of a positive legal provision would have been an illegal/fraudulent, thus, punishable activity. But this italicized bit read with the *obiter* observations of the judge on morality of tax avoidance in a welfare state, does tend to give the impression that all tax avoidance schemes have been declared illegal. This confusion, as we will see will be taken care of the in post *McDowell* opinions.But it was the needless moral sermon delivered by Justice Reddy that will be questioned immediately.

B. Post McDowell Position (1986-2014)

The decision in *McDowell* did not get a warm welcome from the Bar and was criticized almost instantly. Describing *McDowell* as a case of 'great public importance', Palkhivala criticized the decision as 'blurring the distinction between tax avoidance which is legitimate and tax evasion which is not'.[256] Palkhivala's critique was broadly based on three points – (i) the English opinions were read out of context, (ii) the House of Lords had actually 'expressly reaffirmed' the basic principle that a taxpayer was entitled to arrange his affairs so as to reduce his tax liability, and (iii) *Westminster* was never

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[254] *Ibid.*, at 654.

[255] David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 23 (2011).

[256] Nani A. Palkhivala, *We, the Nation: The Lost Decades* 131 (2010). But *see* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 277 (2009), where it is pointed out that as a result of increasing tax shelter activity, this line, on facts is also getting increasingly blurred. This is also demonstrably true if one examines the factual nature of the cases that is getting increasingly complex. *See also* Brea E. L'Heureux, "Why Common Law Calculus Failed: An Analysis of the Economic Substance" Doctrine in *Klamath Strategic Investment Fund* v. *United States*, 64 Tax Law 471, 473 (2011).

overruled by House of Lords.[257] After criticizing *McDowell* as an opinion as based on a misinterpretation and indiscriminate and thoughtless application of the English cases cited therein, he felt 'reassured' that in *CWT* v. *Arvind Narottam*,[258] the Court had not gone the *McDowell* path.[259]

An examination of the post *McDowell* opinions on the point shows that the *McDowell* principle was never quite accepted by the subsequent benches of the Supreme Court. On every occasion where the holdings of Justice Reddy could have been followed, distinctions were made to justify that the law as laid down in *McDowell* was not really applicable to the facts of the particular case under consideration. Take, for instance, the division bench opinion delivered in the 1988 case of *CWT* v. *Arvind Narottam*. The taxpayer had created two trusts, identical in terms except in regards to the minimum amount payable to the beneficiaries, for the benefit of himself, his wife, children and grandchildren.[260] The wealth tax officer imposed wealth tax on the entire value of the assets held by the trusts, which, on appeal, were reduced to the capitalized value of the minimum amounts payable under the trust deeds by the Appellate Commissioner.[261] The Appellate Tribunal upheld Commissioner's view but the High Court reversed both the Commissioner and the wealth tax officer.[262] Before the Supreme Court, the revenue authorities, relying on *McDowell*,[263] took the stand that 'in the case of a discretionary trust the interest of the beneficiary extends not only to the actual share paid to him but to his right to be considered as a potential recipient of the net income remaining after defraying the management expenses and paying the taxes'.[264] The argument was rejected by Chief Justice Pathak and he held that only the amount to which the taxpayer was entitled to could he claim as his property and, thus, on that alone could the tax be imposed.[265] The concurring judge, Justice Mukharji (later Chief Justice) questioned whether Justice Reddy in *McDowell* laid down a practical principle and observed that –

> One would wish, as noted by Reddy, J that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary tax payers very often in a country of shortages with ostentatious consumption and deprivation for the large masses ask is

257 Nani A. Palkhivala, *We, the Nation: The Lost Decades* 131-32 (2010).
258 *CWT* v. *Arvind Narottam*, (1988) 4 SCC 113.
259 *Ibid.*, at 132, 133.
260 *Ibid.*, at 115.
261 *Ibid.*, at 117.
262 *Ibid.*
263 *Ibid.*, at 120.
264 *Ibid.*, at 118.
265 *Ibid.*, at 119.

> does he facilitate the wastes and ostentatiousness of the few. Unless wastes and ostentatiousness in government's spending are avoided or eschewed no amount of moral sermons would change people's attitude to tax avoidance.[266]

Talking about the morality of tax evasion and expressing a sentiment similar to these, Palkhivala wrote that people generally fell into three categories – those who would honestly pay taxes, no matter how heavy the burden; those would be dishonest and never pay taxes, no matter how light the burden and those that basically honest but 'the nature of whose response to the law is conditioned by the quality of the law'.[267] Tax laws in India, Palkhivala observed, 'ignores the first, is preoccupied with the second, and alienates the third'.[268] Exposing the deep divide between the morality of tax evasion and the reality of tax avoidance, Palkhivala observed that while 'ideologues and academics spend hours' convincing themselves that high rates of personal taxation are essential in a socialist economy, the people 'persistent in their obstinate belief that the State is not entitled to take more than half of their income… are prepared to resort to various devices, even at the risk of being prosecuted, to keep a fair share of their own earnings.'[269]

Speaking again for the Court, through a division bench, in 1989, Justice Mukharji again questioned the *McDowell* holding, in *Union of India* v. *Playworld Electronics (P) Ltd.*[270] This case involved the dispute over evasion of payment of excise duty. If a taxpayer sold the goods he manufactured to a 'related person' or a 'favoured buyer', the concessional rate of duty that was applicable to certain goods (in this case wireless receiving sets, tape recorders and tape payers) could be denied to the taxpayer.[271] A related person was defined to be 'a person who is so associated with the assessee that they have interest, directly or indirectly, in the business of each other.[272] If such was the case, then excise duty was to be imposed on the 'price at which such goods

[266] *Ibid.*, at 121.

[267] Nani A. Palkhivala, *We, The People* 120 (2009).

[268] *Ibid.*, *See also* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 264 (2009). Kovach brings about another angle to this morality debate by pointing out that, "… the moral underpinnings of a tax system based on voluntary compliance would weaken when groups of taxpayers, because of their unique circumstances, gain access to tax shelters not generally available to the entire population of taxpayers".

[269] *Ibid.*, at 157. *See also* Brea E. L'Heureux, "Why Common Law Calculus Failed: An Analysis of the Economic Substance Doctrine" in *Klamath Strategic Investment Fund* v. *United States*, 64 Tax Law 471, 472 (2011). The note argues that, "A high-rate tax regime gives clever individuals a powerful incentive to game the system."

[270] *Union of India* v. *Playworld Electronics (P) Ltd.*, (1989) 3 SCC 181.

[271] *Ibid.*, at 183.

[272] *Ibid.*, at 185.

were ordinarily sold by the assessee to a buyer'.[273] Naturally, the dispute arose as the sale transactions by the taxpayer were contended by the revenue, *inter alia* relying on *McDowell*[274], to be made to a 'related person' while the purchaser was denied to be a 'related person' by the taxpayer. It would be profitable to keep in mind here that *McDowell* was a case in which, on facts, the dispute was about imposition of excise duty on liquor. Justice Mukharji, citing the view he had taken in *Narottam*,[275] held that the Court needed to examine 'the true nature of the transaction' in order to resolve alleged tax evasion disputes.[276] Clearly, being of the view that *McDowell* was perhaps not correctly decided, he observed that it is unsafe to make bad laws out of hard facts.[277]

A strong blow was struck to *McDowell* in 2004 by a division bench of the Court in *Indo-Mauritius DTAA case*.[278] Perhaps the most comprehensive opinion on the point, this case cites/discusses a total of 62 judicial opinions including amongst them several key pre *McDowell* opinions, several leading English and United States opinions including the famous *Gregory* v. *Helvering*. The legal dispute, in this case, arose out of a Circular issued by the Central Board of Direct Taxes with regard to the assessment of cases in which the Indo-Mauritius Double Taxation Avoidance Convention of 1983 was applied.[279] The purpose of the 1983 Convention was to avoid double taxation, encourage mutual trade and investment, and 'bring an environment of certainty in matters of tax affairs in both countries'.[280] As per the impugned Circular, directions were given that capital gains of any resident of Mauritius by way of sales of shares on an Indian corporation were to be taxable in Mauritius only and not in India.[281] Consequently several Foreign Institutional Investors (FIIs) in Mauritius invested money in India by purchasing shares of Indian corporations.[282] All these FIIs were then issued notices by Revenue as to why they should not be taxed in India on the profits and dividends accrued to them in India on the ground that they were 'shell companies' created only to invest funds in India.[283] A civil society activist group challenged the validity of this Circular[284], relying 'heavily' on the

[273] *Ibid.*, at 184.
[274] *Ibid.*, at 190.
[275] *Ibid.*, at 19.
[276] *Ibid.*, at 190-91.
[277] *Ibid.*, at 191.
[278] *Union of India* v. *Azadi Bachao Andolan*, (2004) 10 SCC 1.
[279] *Ibid.*, at 16.
[280] *Ibid.*
[281] *Ibid.*, at 18-19.
[282] *Ibid.*, at 19.
[283] *Ibid.*, at 19, 48.
[284] *Ibid.*, at 20.

authority of *McDowell* characterized these shell companies as 'sham' and a mere 'device actuated by improper motives'[285] and argued that 'any tax planning which is intended to and results in avoidance of tax must be struck down' by the Supreme Court.[286] The view that all tax planning is illegitimate, based on Justice Reddy's views in *McDowell* was totally rejected by the Court.[287] The mode of judicial reasoning that was adopted here will be later affirmed, and more elaborately, employed in *Vodafone* except this time by a unanimous three judge bench. Justice Srikrishna read the views of Justice Reddy in *McDowell* and believes that they were controlled and delimited by the majority view expressed by Justice Mishra (later Chief Justice).[288] It was also held, on the authority of subsequent English decisions that far from having been exorcised *Westminster* actually 'continues to be alive and kicking in England'.[289] *McDowell*, therefore, was only a 'temporary turbulence' in India.[290] The position in United States was also considered but only very briefly and *Gregory* v. *Helvering* was cited only by way of a footnote though some other U.S. opinions were quoted from, again briefly.[291]

The decisive blow that was dealt to *McDowell*, in 2012, in *Vodafone case*. But before we examine *Vodafone case*, we may quickly note two division bench opinions delivered in 2010. The first one, *CIT* v. *Ashini Lease Finance (P) Ltd*.[292] is a very short one, which may fairly be described as a text-book case of use of colourable tax avoidance. The taxpayer corporation loaned money to its subsidiary corporation so that the subsidiary could acquire controlling shares in another corporation; the subsidiary paid interest on that loan to the taxpayer corporation and later claimed interest expenses in its income tax returns.[293] Describing this transaction as a 'circular transaction', Justice Kapadia (later Chief Justice) dismissed the taxpayer's appeal.[294] In the second, the Supreme Court was presented with another transaction, which would be described as a 'dividend stripping' transaction, in a batch of income tax appeals in *CIT* v. *Walfort Share and Stock Brokers (P) Ltd*.[295]

285 *Ibid*., at 54, 55.
286 *Ibid*., at 54-55.
287 *Ibid*., at 56. Justice Srikrishna (for the Court) holding that, "We are afraid we are unable to read or comprehend the majority judgment in *McDowell* as having endorsed this extreme view of Chinnappa Reddy, J., which in our considered opinion, actually militates against the observations of the majority of the Judges we have just extracted from the leading judgment of Ranganath Mishra, J. (as he then was)." (Internal Citations Omitted)
288 *Ibid*., at 55-56.
289 *Ibid*., at 55, 56, 5.
290 *Ibid*., at 61.
291 *Ibid*., at 61-62.
292 *CIT* v. *Ashini Lease Finance (P) Ltd*., (2010) 14 SCC 795.
293 *Ibid*., at 796.
294 *Ibid*.
295 *CIT* v. *Walfort Share and Stock Brokers (P) Ltd*., (2010) 8 SCC 137.

where a different view was taken. In this case, the taxpayer purchased a security, on which he earned tax-free dividend but later the price of the security dropped and he sold the security incurring a loss, the amount of the loss and the tax-free dividend being identical.[296] The loss was claimed by the taxpayer on the income-tax returns that resulted in the net taxable income going down and was rejected by the income tax officer.[297] The income tax officer's view was upheld by the Appellate Commissioner but was rejected in the ITAT. ITAT's order was upheld by the High Court.[298] We should note here that the dividend that was earned by the taxpayer was tax-free in the first place. The problem for the revenue authorities was that the loss could not be claimed only against the tax-free dividend but could also be claimed against the entire income, thus, reducing the entire taxable income.[299]The revenue authorities, before the Supreme Court, tried to create a distinction between a 'tax loss' and a 'commercial loss' and characterized this 'dividend-stripping transaction' as a 'tax loss' that was contrived without suffering any corresponding 'commercial loss'.[300]

The first question before the Court was whether the loss as claimed by the taxpayer could be allowed being considered as expenditure in relation to earning of dividend income that was exempt from income tax anyway?[301] This question was answered against the taxpayer.[302] The second question was whether this loss could be disallowed on the ground this was a dividend-stripping transaction i.e. a premeditated transaction calculated to create a deliberate loss?[303] The loss was disallowed by the income tax officer on the ground that the transaction was entered into by the taxpayer 'with full knowledge about the guaranteed fall in the market value of the units'[304] But, because the revenue authorities were not able to produce any evidence of this 'full knowledge' it was held that there was 'nothing to impeach the

296 *Ibid.*, at 142.
297 *Ibid.*, at 142-43.
298 *Ibid.*, at 143.
299 *Ibid.*, at 153. The revenue's "real objection" as recorded in the opinion was in fact framed pretty much in these exact words.
300 *Ibid.*, at 144. An argument strikingly similar was made in the US Supreme Court by the IRS in *Gitlitz* v. *Commr. of Internal Revenue*, 2001 SCC OnLine US SC 2 : 148 L Ed 2d 613 : 531 US 206 (2001) where a transaction had produced a tax loss without the taxpayer incurring an accompanying economic loss. IRS lost as the Court took the view that since the text of the statute permitted the taxpayers to receive this benefit there was no ground to intervene. *See also* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 28 (2011).
301 *Ibid.*, at 150.
302 *Ibid.*, at 152.
303 *Ibid.*
304 *Ibid.*, at 152-53.

genuineness of the transaction'.[305] It was in the context of the second question that it was held by Chief Justice Kapadia that –

With regard to the ruling in [*McDowell*], it may be stated that in the later decision of this Court in [*Indo-Mauritius DTAA case*] it has been held that a citizen is free to carry on its business within the four corners of the law. That, mere tax planning, without any motive to evade taxes through colourable devices is not frowned upon even by the judgment of this Court in [*McDowell*].[306]

Vodafone case is a long decision to study. Two concurring opinions delivered in this case span a total of 103 pages (excluding case-notes) in the law report Supreme Court Cases.[307] The opinion delivered by Chief Justice Kapadia (for himself and Justice Swatanter Kumar) is 39 pages long ('the Lead Opinion')[308] and Justice Radhakrishnan's concurring opinion is 64 pages long ('the Concurring Opinion').[309] Facts of the case, for the purpose of our analysis, are taken from the Lead Opinion. Briefly, they are as follows. A Dutch company 'Vodafone Int'l Holdings' ('Vodafone Int'l') acquired the entire share capital of a Cayman Islands company 'CGP Investments' ('CGP').[310] CGP, in turn, though indirectly, held 52% shareholding interest, with an option to acquire further 15% shareholding, in an Indian company 'Hutchison Essar Ltd.' ('Hutch India').[311] As a result of this transaction, Vodafone Int'l ended up acquiring 67% controlling interest in Hutch India.[312] Indian revenue authorities were of the view that capital gains tax was capable of being levied on the transaction between Vodafone Int'l and CGP on the ground that CGP, even though not resident in India, held underlying Indian assets.[313] The complex nature of this transaction can gauged by examining the detailed ownership structure chart reproduced in the Lead Opinion.[314] After narrating the facts of the case,[315] the Lead Opinion goes directly to the 'tax avoidance versus tax evasion' issue.[316]

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305 *Ibid.*, at 153.
306 *Ibid.*
307 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 654-757.
308 *Ibid.*, at 654-693.
309 *Ibid.*, at 693-757.
310 *Ibid.*, at 654.
311 *Ibid.*, at 654, 666. Chief Justice Kapadia (majority opinion) found, "To sum up, CGP held 42.34% in [Hutch India] through 100% wholly owned subsidiaries (Mauritius companies), 9.62% indirectly through TII and Omega (i.e. pro rata route), and 15.03% through GSPL route."
312 *Ibid.*
313 *Ibid.*
314 *Ibid.*, at 664-665.
315 *Ibid.*, at 654-665.
316 *Ibid.*, at 666.

The issue was framed, from the very beginning, as a conflict of judicial opinion between the unanimous five judge bench opinion in *McDowell*[317] and the *Indo-Mauritius DTAA case* with the revenue authoritiesbuilding their argument by questioning the correctness of the latter decision.[318] Relying on *McDowell* and arguing that *Indo-Mauritius DTAA case* had misunderstood the holding in *McDowell*, the revenue authorities'position essentially was that while tax evasion is certainly illegal, in certain circumstances, their legality notwithstanding, even tax avoidance transactions could be brought within the tax ambit since this is what Justice Chinnappa Reddy had held in *McDowell*.[319] Central to this argument raised by the Revenue were two famous English (House of Lords) decisions – *Westminster*[320] and *Ramsay*.[321] *Ramsay* was distinguished by *Westminster* and it was held that –

> *Ramsay* did not discard *Westminster* but read it in the proper context by which a "device" which was colourable in nature had to be ignored as fiscal nullity. *Thus, Ramsay lays down the principle of statutory interpretation rather than an over-arching anti-avoidance doctrine imposed upon tax laws*.[322]

Speaking of the use of colourable devices the Lead Opinion also cited *Dawson*[323] where the 'Step Transaction Doctrine' was put in place.[324] As per this case, if a series of transactions have no business purpose but have been inserted only to avoid taxation, the Courts may disregard such steps. This doctrine is also referred to as 'Wash Transactions Doctrine' and is a judicially recognized doctrine in the United States as well. The subsequent misuse of *Dawson* by revenue authorities was also noted,[325] which resulted in *Craven* v. *White*[326] where the House of Lords reiterated that genuine tax

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317 *McDowell and Co. Ltd.* v. *CTO*, (1985) 3 SCC 230.

318 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 666.

319 *Ibid*.

320 *Commrs. of Inland Revenue* v. *Duke of Westminster*, 1936 AC 1 (HL). In this case it was held that if a transaction is genuine, the Courts are not allowed to go behind the supposed underlying substance of the transaction.

321 *W.T. Ramsay Ltd.* v. *Inland Revenue Commrs.*, 1982 AC 300 (HL). The Revenue contented that the *Westminster* principle (i.e. the form over substance test) had been abandoned by the House of Lords in *Ramsay* and therefore *Westminster* principle could not be applied in *Vodafone case*.

322 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667.

323 *Furniss* v. *Dawson*, 1984 AC 474 (HL).

324 *Ibid*., cited at *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667.

325 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667-668. Chief Justice Kapadia noted that, "… the Revenue started rejecting every case of strategic investment/tax planning undertaken years before the event saying that the insertion of the entity was effected with the sole intention of tax avoidance."

326 1989 AC 389 (HL).

planning was not hit by *Dawson*.[327] At this point, Chief Justice Kapadia did something that requires a close reading of *McDowell*. Justice Misra, in *McDowell*, had held as follows –

> Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.[328]

After having held so, he observed, "*On this aspect* one of us, Chinnappa Reddy, J., has proposed a separate and detailed opinion, *with which we agree*".[329] Thereafter, Justice Misra proceeded to dispose of the petition and grant the relief that was prayed for. Chief Justice Kapadia, in the Lead Opinion, uses this phrase '*on this aspect*' to narrow down the holding of Justice Reddy.[330] Thus, even though the majority (of 4 judges) in *McDowell* concurred with the separate concurring opinion, the content of what the majority concurred with was narrowed down by giving context of the separate concurring opinion – a context that came out of the majority opinion and a legal position that has been firmly established and followed in India long before Justice Reddy wrote his concurrence in *McDowell* and long after the content of his concurrence was subsequently diluted by post McDowell decisions.

But the Concurring Opinion opens with a steady dose of reality. The very first paragraph notes that foreign investment in India is generally routed through offshore financial centers and through countries with whom India has entered into treaties.[331] Vodafone Int'l argued that complex commercial transactions, such as the one under judicial scrutiny in this case, are designed for good commercial reasons and not just tax avoidance.[332] There was a special international context to this whole case and the Concurring Opinion grasped this very quickly.[333] Justice Radhakrishnan understood that there

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[327] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 688.

[328] *McDowell and Co. Ltd.* v. *CTO*, (1985) 3 SCC 230, 254-55.

[329] *Ibid.* (emphasis added).

[330] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 668.

[331] *Ibid.*, at 693.

[332] *Ibid.*, at 704 (Arguments of Vodafone Int'l's counsel, Mr. Harish N. Salve, Senior Advocate).

[333] *See e.g.*, *Ibid.*, at 711. Justice Radhakrishnan (concurring), "**Tax avoidance is a problem faced by almost all countries following civil and common law systems and all share the common broad aim, that is to combat it.** Many countries are taking various legislative measures to increase the scrutiny of transactions concluded by non-resident enterprises." (emphasis added)

is a difference between a corporate structure that is the result of investment decisions and those that are created only for tax avoidance.[334] Take, for instance, the following observation –

> In transnational investments, the use of tax neutral and investor-friendly countries to establish an [Special Purpose Vehicle] is motivated by the need to create a tax efficient structure to eliminate double taxation wherever possible and also plan their activities attracting no or lesser tax so as to give maximum benefit to the investor.[335]

Justice Radhakrishnan begins his 'tax avoidance versus tax evasion' with the famous *Westminster* citing it as an authority for the proposition that in tax avoidance cases, as per *Westminster*, tax laws are to be strictly interpreted and the legal form of the arrangement is to be examined, notwithstanding its economic or commercial substance.[336] Citing *Ramsay* and *Burmah Oil*[337] as authorities for the next proposition, he observes that it was only during the 1980s that the House of Lords moved towards a more purposive interpretation.Consequently, the Economic Substance Doctrine was put in place[338] but *Westminster* was still good law.[339] But, he carefully notes that *Ramsay* and *Burmah Oil* were the result of readymade transactions, a series of self-cancelling transactions that was designed to create allowable losses with the intent of avoiding capital gains tax.[340] The difficulty arose with *Dawson* where the House of Lords, dealing with a non-self-cancelling transaction, held that, '...steps inserted in a *preordained* series of transactions with no commercial purpose other than tax avoidance should be disregarded for tax purposes, notwithstanding that the inserted step... had a business effect',[341] thus, causing the appearance that the House of Lords had held that all transactions having a tax avoidance purpose were to be disregarded for that reason alone.[342]But later, in *Craven*, the House of Lords clarified,

> ...an intermediate transfer which was, at the time when it was effected, so closely interconnected with the ultimate disposition, could properly be described as not, in itself, a real transaction at all, but merely an element in some different and larger whole without independent effect.[343]

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334 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 708.
335 *Ibid.*
336 *Ibid.*, at 719-20.
337 *Inland Revenue Commrs.* v. *Burmah Oil Co. Ltd.*, 1982 SC (HL) 114.
338 *Ibid.*, at 720.
339 *Ibid.*
340 *Ibid.*, at 721.
341 *Ibid.*, at 722.
342 *Ibid.*
343 *Ibid.*, at 723.

Note here at this point of time i.e. after discussing *Craven*, the Chief Justice stopped and moved to the conflict between *McDowell* and *Indo-Mauritius DTAA case.* But Justice Radhakrishnan decides to examine more English precedents on the point. After discussing 6 more English cases (5 of them being House of Lords decisions),[344] he concluded–

> The above discussion would indicate *that a clear-cut distinction between tax avoidance and tax evasion is still to emerge in England and in absence of any legislative guidelines there is bound to be uncertainty, but to say that the principle of* [Westminster] *has been exorcised in English is too tall a statement and not seen accepted even in England.*[345]

This observation is interesting to note because in *McDowell* Justice Reddy called for 'exorcising the ghost of Westminster'. This broad survey of English law on the subject was Justice Radhakrishnan's way of saying that perhaps Justice Reddy did not get it right in his concurrent opinion in *McDowell.* After pointing out that Westminster is still good law in the jurisdiction where it originated, he then moves to examining the conflict between *McDowell* and *Indo-Mauritius DTAA case.*[346]

Let us be with Justice Radhakrishnan's conclusion on the point. After discussing *McDowell* and *Indo-Mauritius DTAA case* and some other relevant Indian precedents on the point that we will examine later, he concluded–

> *The Revenue cannot tax a subject without a statute to support and in the course we also acknowledge that every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury.* The Revenue's stand that the ratio laid down in *McDowell* is contrary to what has been laid down in [*Indo-Mauritius DTAA case*], in our view, unsustainable and, therefore, calls for no reconsideration by a larger Bench.[347]

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[344] *Ensign Tankers (Leasing) Ltd.* v. *Stokes*, (1992) 1 AC 655 (HL), *Floor* v. *Davis*, 1978 Ch 295 : (1978) 3 WLR 360 (CA); *Inland Revenue Commrs.* v. *McGuckian*, (1997) 1 WLR 991 : (1997) 3 All ER 817 (HL); *MacNiven* v. *Westmoreland Investment Ltd.*, (2003) 1 AC 311 (HL); *Barclays Mercantile Business Finance Ltd.* v. *Mawson*, (2005) 1 AC 684 (HL); *Inland Revenue Commrs.* v. *Scottish Provident Institution*, (2005) 1 WLR 3172 : (2005) 1 All ER 325 (HL).

[345] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 725. (emphasis provided).

[346] *Ibid.*, at 726.

[347] *Ibid.*, at 733. (emphasis provided).

To support this finding he gave two reasons. First reason was the same as that given by the Chief Justice, which has been discussed previously. The lead opinion in *McDowell* was delivered by Justice Misra and Justice Reddy, per his own opinion, was only writing a supplemental concurrence.[348] Therefore, it was Justice Misra's opinion that should be read and used to provide context and limitations to the opinion of Justice Reddy. The second reason had to do with the 'ghost of Westminster' observation in Justice Reddy's concurrence in *McDowell*, which Justice Radhakrishnan held was merely Justice Reddy's opinion and not good law.[349]

Conclusion

Supreme Court of India's juristic technique, in cases of tax avoidance disputes, discloses two distinct decision making methods. The traditional approach uses one of several interpretational principles.[350] As per this approach, one of these principles is either invoked and then applied or is invoked and then improved upon. These principles, as identified in Part 2, are the 'Legislative Intent Rule', the 'Textual Rule', the 'Minimum Liability Rule', the 'Strict Interpretation Rule', and the 'Restrictive Strict Interpretation Rule'. We can call this the 'Interpretational Approach'.[351] The other approach, which we can call the 'Judicial Test Approach', begins to appeal where the judges, while following the Interpretational Approach realized that in certain factual scenarios, or even the way the taxation statute was drafted, the interpretation principles because of their inherent limitations cannot be used to resolve the question completely.In this situation, the judges will either respond by creating a new rule of interpretation,[352] and, at other times, judges would articulate a judicial test.[353]

A crucial distinction between these two approaches should be noted. In the Interpretational Approach, the content of the interpretational rule

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[348] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 733.

[349] *Ibid*., at 732.

[350] *Supra* Parts 2.1 (I), (II), (III), (IV).

[351] *See* Brian Galle, "Interpretative Theory and Tax Shelter Regulation", 26 Va. Tax Rev. 357 (2007) at 358. Brian Galle describes, "The practice of tax law is fundamentally the practice of statutory interpretation."

[352] The Strict Interpretation Rule was the result of just such a situation that has been discussed *supra* Part 2.1 (IV).

[353] *Supra* Parts 2.1 (VI), (VII), (VIII), (IX). But *see also* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 264 (2009) for a different take. Kovach says that, "Those taxpayers who [are] not in a position to apply bastardized interpretations of the business deduction rules ... would resent their inability to save taxes this way." (Internal citations omitted).

remains constant even though the facts of the next case inevitably would be different from the previous ones. This consistency, in the content of the interpretational principle, is disturbed only when a new rule of interpretation is developed, or perhaps even discovered. But in this case also, the content of the old rules remains the same and a new rule is now added to the judicial tool kit. The content of this new rule also remains constant in future. This consistency in the Interpretational Approach gives a measure of predictability to the judicial decisions. Even though no one can really predict what a court will decide in any given case, by looking at the judicial decision making methodology one can reasonably assess what the decision in a given case is going to be.

In the Judicial Test Approach, however, the content of the judicial test remains subject to constant change depending on the facts of the next case. Since a judicial test has been articulated in the specific factual context of that case, it is inevitably going to be coloured by the legal question(s) raised in that case. Since the facts of no two cases are the same, or at least as the Bar would have it anyway, any judicial test is subject to constant modification and re-articulation depending of the facts of the next case and this cycle continues perpetually. This gives a certain measure of unpredictability to the judicial decisions because there is no way to know what gloss might be put over the judicial test in a given case. But the very existence of the Judicial Test Approach is, in itself, evidence of the fact that the Interpretational Approach has its limitations and the most efficient way to get over its limitations are sometimes to articulate a judicial test.

Following the Judicial Test Approach, the Supreme Court of India has developed some judicial tests *viz*. the 'Ordinary Course of Business' test, the 'Prudent Businessman Yardstick', the 'Bonafide Commercial Transaction' test and the 'Commercial Expediency' test. The problem.However, is that there is no coherent methodology in India whereby either the Bench or the Bar can discern the situations where the Interpretational Approach would be taken and where the Judicial Test Approach would be taken by the Court. Furthermore, the Interpretational Approach is essentially based on a statutory rule and is by definition restricted in its scope because all the judge can do is either expand or contract the competing meanings assigned to the text. [354]For example, it can be said the 'Commercial Expediency Test' has worked very well in its narrow sphere. But that is only because everyone knows how this test is to be applied and the content of the test has remained fairly stable. This demonstrates that for a judicial test to fare well in long term it is not just desirable but necessary for the content of the test to remain stable and

[354] *See e.g.*, David A. Weisbach, "Formalism in the Tax Law", 66 U. Chi. L. Rev. 860 (1999).

for it to be very clear in what situations the test can be invoked.[355] However, the Judicial Test Approach, being a departure from the Interpretational Approach for the reason that principles of interpretation cannot offer full assistance in answering the legal question raised, it must first be seen that this is indeed the case. This is where perhaps the *Vodafone case* bench fell into a classical confusion by failing to realize whether the legal question can be answered using the Interpretational Approach or the need to take the Judicial Test Approach has arisen.

By laying down the several interpretational principles that hold this field in the complex area of tax avoidance jurisprudence, as well as the judicial tests that the Supreme Court has laid down, and by distinguishing when the Interpretational Approach is best suited to resolve the conflict and when the Judicial Test Approach fares better, this article hopes to fill this crucial gap in scholarship. We can conclude by reproducing in full a quote made in 1937 by a highly respected US tax lawyer Randolph E. Paul that perhaps most accurately captures the confusion, and one that this article hopes to have clarified

> Confusion is often introduced or multiplied by a failure to distinguish between questions of fact and questions of law. In the *fact* cases the paramount question is always essentially the same. Has the taxpayer really done what he professes he has done? Has he actually taken the steps on which his attempt at avoidance was based? … The second type of question, one of *law*, not *fact*, … is how the law is to be construed in relation to the facts proved. Here, rules of statutory construction are relevant.[356]

[355] *See e.g.*, Martin A. Chirelstein, *supra* note 53. Chirelstein says that, "… the ability to perceive alternatives in great numbers can sometimes by a dangerous intelligence unless it is combined with a power to forecast the likely reaction of the Service and the courts to each of the alternatives in view".

[356] Walter J. Blum, "*Knetsch* v. *United States*: A Pronouncement on Tax Avoidance", 1961 Sup. Ct. Rev. 135, 143 (1961) where he reproduces Paul's observations; the original source cited by Blum is Paul, Studies in Federal Taxation 130 (1937).