I. Introduction

The concept of a Company as a business structure is founded on the premise that it has a legal personality that is separate and distinct from that of its owners. Consequently, the legal framework pertaining to a company’s operations and obligations acknowledges separate legal existence as a key feature of the company structure. Lifting or piercing the veil of corporate personality means that the company is no longer viewed as a distinct entity. On the other hand, the company is seen as being no different from the persons who own the shareholding of the company. The initial trend among common law jurisdictions was that the veil of corporate personality should not be lifted under normal circumstances. With the passage of time and the growing complexity of transactions and the laws which govern them, the Courts have become more agreeable to piercing the corporate veil. This trend has been particularly strong in the case of tax matters.

The law is an instrument of government policy. Importantly, the business law framework is expected to reflect and supplement the economic vision of the country. The legislature formulates laws to develop business structures, encourage business transactions and promote investment. It is but a natural effect of a business friendly environment for businesses to use the legal framework to maximize profits and minimize costs and other liabilities. Piercing the corporate veil could potentially affect these objectives. There is however another perspective. Too often, there have been instances where dishonest elements have used legal subterfuges to evade tax liability. This directly affects tax collection by the revenue. Any meaningful discussion on piercing the corporate veil will have to factor both these perspectives.

No doubt there is a thin line that demarcates tax evasion and tax avoidance. The former is a patent illegality whereas the latter allows taxpayers to organize their tax liability within the boundaries of the law.1 Two judgments – the Vodafone judgment from the Bombay High Court and the Richter Holding judgment from the Karnataka High Court have provoked discussion on lifting the corporate veil in taxation matters. A significant theoretical question that arises from this discussion is whether the principle of piercing the veil of corporate personality can be limited to checking illegal transactions.

This research paper seeks to understand and analyze the law relating to piercing the corporate veil. The paper first seeks to briefly discuss the historical background behind lifting the corporate veil. Thereafter the paper seeks to analyze the specific reasons for lifting the corporate veil in the context of the Income Tax Act, 1961 and judicial pronouncements. Following this, the paper investigates into the scheme of the Direct Taxes Code and seeks to assess the implications of the General Anti-Avoidance Rule. Further, the paper compares this principle with synonymous and corresponding features in other tax jurisdictions. Finally this paper suggests reforms to the law and concludes.

II. A Brief History of the Doctrine

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1 Taxing International Transactions By Lifting The Corporate Veil

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At the very outset, it is important to trace the development of the doctrine of piercing the corporate veil. This is only possible if the history of the company structure is examined. The corporation mode of conducting trade and business fully emerged as a successful business model around the same time when Great Britain was experiencing the Industrial Revolution. Corporate personality became a key instrument of industrialization in that it encouraged reluctant entrepreneurs by offering them a legal structure that limits risk.

A company by virtue of its incorporation enjoys the advantage of a separate legal entity. It is an artificial person which is capable of enjoying rights and of being subject to duties which are not the same as enjoyed by its members.2 Thus personality of the company is separate from that of its members. However, when the members of the company employ legal or corporate personality to serve an unjust and inequitable purpose or evade legal obligations, the court refuses to maintain the separation. In such circumstances, the veil of incorporation is to be lifted.3

Simply stated, by applying the doctrine of ‘piercing the corporate veil’, courts disregard the separate corporate existence of the company and fix liability on the Directors or other officers of the company as the case may be.4 Most companies are organized on the basis of limited liability meaning thereby that the liability of each shareholder of the company is limited to the face value of the shares held by him.

In Salomon v Salomon & Co.5 Lord MacNaughten rejected the plea of creditors that the corporate veil be lifted and that the primary shareholder be made to repay the debts of the company. One of the earlier instances where the Court pierced the corporate veil was in the case of Gilford Motor Company Limited v Horne.6 The Court held that the Defendant company was established for the sole purpose of defeating a covenant that prohibited the Defendant from soliciting clients from his previous employer. The Hon'ble Supreme Court observed in State of U.P. and Ors. v Renusagar Power Co. and Ors’7 that “It is high time to reiterate that in the expanding of horizons of modern jurisprudence, lifting of corporate veil is permissible. Its frontiers are unlimited. It must, however depend primarily on the realities of the situation.” Prior to this case, the Supreme Court held in Tata Engineering and Locomotive Company Ltd. v State of Bihar,8 the that doctrine of lifting of the veil postulates the existence of dualism between the corporation or company on the one hand and its members or shareholders on the other.

III. Analysis of the Doctrine in India

The company structure came to be used as a means of reducing tax liability by either minimizing tax exposure within legal limits or by altogether evading tax. This triggered the application of the doctrine to tax matters. The expectation was that by piercing the corporate veil, tax defaulters could be identified and losses to the exchequer recovered. The concern of the present discussion is to assess how far this expectation has been met and whether a rigorous application of this doctrine has resulted in any negative fallout.

Discussion on the doctrine of piercing the corporate veil in tax matters was reinvigorated with the increase of cross-border business transactions, particularly those transactions which sought to restructure businesses by purchase of assets or by
mergers and amalgamations. Even prior to this however, Indian courts have discussed the doctrine and even applied it in appropriate cases. It is important to briefly peruse these earlier judgments so as to ascertain the parameters on which the Courts have either applied or recommended the application of the doctrine.

Sham Transactions

In Sunil Siddhathbhai v CIT, Ahemedabad,9 the Hon’ble Supreme Court held that in the task of determining whether a transaction is a sham or illusory transaction or a devise or ruse, he is entitled to penetrate the veil covering it and ascertain the truth. In CIT v Sri Meenakshi Mills Ltd. and Ors,10 the Supreme Court, while applying the doctrine, observed that from the juristic point of view, the company is a legal personality entirely distinct from its members. But in certain exceptional cases, the Court is entitled to lift the veil of the corporate entity and to pay regard to the economic realities behind the legal façade.

Evading legal obligations

In Life Insurance Corporation of India v Escorts Ltd.,11 the Hon’ble Supreme Court asserted that the veil may be lifted in cases where the aim is to avoid a taxation statute or to evade obligations imposed by the law or for the protection of public interest. The Calcutta High Court in Bijay Kumar Agarwal vs. Ratanlal Bagania12 observed that the doctrine of piercing the corporate veil will be available in statute like the Companies Act, 1956 and other financial and taxing statutes, but this principle can be used by the court to prevent the abuse of process of law. The Allahabad High Court has observed that the doctrine of “lifting the veil” has marked a change and is adopted whenever and wherever a situation demanded the application of the doctrine.13

In McDowell & Co. Ltd. v. CTO14, it has been held clearly that the taxpayer cannot be allowed to get away with any colourable device or artificial sham transaction. Therefore, it becomes an important function of the income tax authorities to look into the devices and natures of transactions used by the assessee, and decide upon the character and nature of such devices and transactions.

Application in exceptional circumstances only

In Juggilal Kamlapt v. CIT,15 the Hon’ble Supreme Court held that it is well established that the Income Tax authorities are entitled to pierce the veil of corporate entity and look at the reality of the transaction. The Court has the power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligation or to perpetrate fraud. However, the court also observed that the doctrine of lifting the corporate veil ought to be applied only in exceptional circumstances and not as routine matter. Again, in Jindal v CIT16, the Calcutta High Court pierced the corporate veil and found that there was an attempt to circumvent the provisions relating to taxation of deemed dividend and refused to give effect to the corporate identity.

It thus becomes clear that the Courts have consistently emphasized that the standard for lifting the corporate veil is to uncover a sham or illusory transaction that seeks to avoid tax liability or to evade any obligations imposed by the law. In such cases, the Courts will explore the economic realities of the transaction to determine whether any
of these transgresses have actually transpired.

**Role of the Tax Authorities and Courts in Lifting the Corporate Veil**

A company is an independent juristic entity and is expected to conduct its financial affairs in a manner that does not defeat a taxation statute by illegally concealing income or avoiding tax liability. As discussed earlier, there has been a tendency among unscrupulous elements to use the corporate structure for the sole purpose of evading tax. It is under these circumstances that the Courts and tax authorities are empowered to investigate into an assessee’s business and inquire into the economic realities of the assessee’s transactions.

The Punjab and Haryana High Court, while illustrating the position of law opined that the “Assessing Officer or the appellate authorities and even the courts can determine the true legal relation resulting from a transaction. If some device has been used by the assessee to conceal the true nature of the transaction, it is the duty of the taxing authorities to unravel the device and determine its true character. However, the legal effect of the transaction cannot be displaced by probing into the “Substance of the transaction”. The taxing authorities must not look at the matter from their own point but from the point of a prudent businessman. Each case will depend on its own facts. The exercise of jurisdiction cannot be stretched to hold a roving enquiry or a deep probe.”

It is now a settled position of law that the assessing officer is empowered to lift the corporate veil during regular assessment proceedings. Moreover, the Tribunal which is statutorily established as the final fact-finding authority cannot act as a mute spectator to a glaringly illegal transaction. The Tribunal, under such circumstances needs to pierce the corporate veil to unearth the real intention of the parties.

At this juncture it is important to note that the Courts have briefly adjudicated on this point. The Delhi High Court had quashed CBDT Circular 789 dated 13 April, 2000. The Circular prohibited the tax authorities from performing any roving enquiry into businesses based in Mauritius. Thus by quashing the circular, the Delhi High Court permitted the tax authorities to lift the corporate veil. Shortly afterwards, the Hon’ble Supreme Court overruled the decision of the Delhi High Court and thereby restored the validity of the Circular No. 789. The Supreme Court observed that tax treaties are entered into at the political level and that treaty shopping is legitimate means of attracting foreign investment. More recently, the international taxation wing of the Income Tax Department and the foreign taxation unit of the CBDT have begun an exercise titled “Lifting Corporate Veil” to investigate over 100 offshore financial structuring deals involving Indian entities.

**IV. Lifting of Corporate Veil in International Transactions**

Over the last decade, Indian business entities have been party to a number of M&A transactions. This is perhaps because the Indian economy has sound fundamentals and an attractive investment climate. Nevertheless, parties to a transaction, particularly a cross-border transaction, always seek to reduce costs of the transaction. International transactions are often in the nature of business reorganization transactions which involve the sale or purchase of assets. Such sale or purchase of assets results in capital
gains tax which parties are keen to avoid.

Applying the doctrine of corporate veil to these transactions can have a profound impact. The Government of India has entered into tax treaties with several nations. Corporations are at liberty to arrange their finances in a manner that will expose them to the least tax liability provided that such arrangement is legal. If the tax authorities are allowed to apply the doctrine, it would unsettle long-standing precedents and would ultimately compel corporations to seek new financial arrangements which could adversely impact the investment climate in India. On the other hand, the doctrine affords tax authorities the opportunity to characterize transactions on the basis of their economic reality and thereby obstruct tax evasion. With a view to further understand the law on point, this paper now briefly discusses the Vodafone and Richter Holdings judgments.

**The Vodafone Story**

Hutchinson International held 100% shares in CGP Investment Holdings Ltd. Hutchinson was a non-resident company whereas CGP Investment was also a non-resident company incorporated in the Cayman Islands. The business was structured in a manner such that CGP Investment was a special purpose vehicle (SPV) which held 67% stake in Hutchinson-Essar which was an Indian company. Vodafone International Holdings BV, a non-resident company acquired the entire share capital of CGP Investment and consequently acquired the stake (67%) held by CGP Investment in Hutchinson-Essar.

Vodafone filed a writ petition before the Bombay High Court challenging the validity of the show-cause notice issued to it by the tax authorities asking the assessee Vodafone why it should not be treated as an assessee-in-default (AID) for failing to withhold tax at source and credit the same to the Central Government with respect to the above transaction. The primary point of discussion was whether the income that accrues to Hutchinson by way of the above transaction can be charged to tax in India by application of s. 9(1)25 of the Income Tax Act, 1961. The Court held that the writ petition was not maintainable since the Petitioner had an alternative, efficacious remedy under the Act and furthermore, the Court upheld the validity of the show cause notice stating that the same was not extraneous, irrelevant or erroneous on the face of it. Vodafone approached the Supreme Court by way of a special leave petition. The Supreme Court dismissed the SLP stating that the jurisdictional issue may be determined by the authority concerned as a preliminary issue.

The case reached the Bombay High Court for the second time. The Court held that whereas a ‘controlling interest’ is merely incidental to the ownership of shares and does not by itself constitute a distinct capital asset under the Act, the transfer of one share in CGP Investment from Hutchinson to Vodafone was merely a fraction of the complex web of structures and arrangements. The Court answered the question of jurisdiction in favour of the tax authorities by laying down that where a source of income or a capital asset is situated in India, all income which accrues directly or indirectly through or from it shall be treated as income which is deemed to arise or accrue in India.

**The Richter Holding Case**
This was a case where Richter Holding, a Cyprus company and West Globe Ltd, a company incorporated in Mauritius purchased and acquired all the shares of Finsider International Company Limited, a company registered in UK from Early Guard Ltd, a UK-registered company. Consequently, Richter Holding indirectly acquired 51% stake in Sesa Goa Ltd, an Indian company which was earlier held by Finsider. The tax authorities issued a show cause notice to Richter Holding for not deducting tax at source in respect of the said acquisition. Richter Holding was aggrieved by the show cause notice and contended that the Assessing Officer had already prejudged the matter.

The Single Judge of the Karnataka High Court held that production of the agreement entered into between Richter Holding and Early Guard is not sufficient to know the nature of the transaction between Finsider and Sesa Goa. Moreover, the Court observed that it may be necessary for the fact finding authority to lift the corporate veil to look into the real nature of the transaction to ascertain virtual facts.

Aggrieved by this, the Appellant preferred an appeal before a Division Bench of the High Court. The Division Bench rejected the Appellant’s apprehensions that the AO had already pre-determined the matter and directed the Appellant to file a reply to the show cause notice within four weeks, further stating that it is open to the Appellant to urge all issues including jurisdiction before the AO.

Both these judgments disclose judicial intent to extend the doctrine of piercing the corporate veil to tax avoidance transactions notwithstanding the fact that such transactions are within the legal framework. It is hard to explain how the transactions in Vodafone or Richter Holdings qualify as sham or colourable transactions. The Supreme Court is now hearing counsel for both parties in the Vodafone matter. Another important takeaway is the willingness of the Courts to exercise the extraterritorial operation of the Act in such matters.

V. The Substance v. Form Debate

The Vodafone judgment re-ignited commentary on the matter of whether the tax authorities and the Courts can disregard the form (legal structure) of a transaction and determine chargeability to tax on the basis of the substance (economic reality) of the transaction. Counsel for Vodafone continuously argued that the business arrangement did not result in a sham transaction and was perfectly legal in form. Counsel for the Revenue contended that the structure put into place by Vodafone was calculated to avoid tax liability. This debate is important because it could have far-reaching ramifications on tax planning.

Substance over form in England

Discussion on the substance vs. form debate normally begins by analyzing the judgment of Inland Revenue Commissioners v Duke of Westminster. Lord Russell observed that given that a document or transaction is genuine, the court cannot go behind it to some underlying substance. Later, in Commissioners of Inland Revenue v Wesleyan and General Assurance Society, Viscount Simon laid down two propositions: First, the name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction and second, a transaction, which on its true construction is of a kind that would escape tax, is not taxable on the ground that the

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same result could be brought about by a transaction in another form that would attract tax. These cases adopt the form over substance principle.

The winds of change began to blow in W. T. Ramsay v Inland Revenue Commissioners. The Ramsay case while accepting the principle laid down in Duke of Westminster as cardinal was cautious to state that the principle must not be overextended. Further the Court held that if it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, there is nothing in the doctrine to prevent it from being so regarded. It was not until Inland Revenue Commissioners v Burmah Oil Co. Ltd that the full significance of the judgment of Ramsay was realized. Lord Scarman observed that the Ramsay case marked a significant change in the approach by the House of Lords in its judicial role towards tax avoidance schemes and that it was now crucial when considering such schemes to take the analysis far enough to determine where the profit, gain or loss is really to be found. Further in Furniss v Dawson, Lord Brightman observed that the fact that the Court accepted that contention that even where each step in a transaction was a genuine step producing its intended legal results, the Court was not confined to considering each step in isolation for the purpose of assessing the fiscal results. These cases suggest that the principle of substance over form came to be adopted in the English courts.

However, there was further churning of the legal position. In Macniven v Westmoreland Investments Limited, the House of Lords, stating that Ramsay did not lay down a new legal principle, held that the need to consider a document or transaction in its proper context and the need to adopt a purposive approach while construing tax legislation are principles of general application which depend on the particular set of facts and the particular statute. Further in the case of Astall & Anor v Revenue and Customs, Arden, LJ while discussing the Ramsay, Burmah and Furniss held that the proposition suggested by these cases that in the application of any taxing statute, transactions or elements of transaction which had no commercial purpose were to be disregarded was going too far. Thus the English law evolved to a position wherein the principle of applying a substance over form approach or vice versa would depend on the particular facts and the particular statute in question.

The Indian Position

The position in India regarding the substance over form principle has been steeped in controversy relating to interpretation. In Commissioner of Income-Tax v A. Raman & Company, a Full Bench of the Supreme Court rejected the Revenue’s characterization of income which could have been earned by the assessee but was not earned as a subterfuge of contrivance and held that avoidance of tax liability by arranging commercial affairs in a manner such that charge of tax is distributed is not prohibited.

Following this was the highly controversial judgment of the Constitution Bench of the Supreme Court in McDowell and Co. Ltd. v Commercial Tax Officer. All five judges were unanimous in dismissing McDowell’s appeal but Chinnappa Reddy, J delivered a separate judgment from Ranganath Mishra, J who was speaking for the other four judges. As per Ranganath Mishra, J, tax planning may be legitimate provided it is within the framework of the law. Colourable devices cannot be a part of the law and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of
tax by resorting to dubious devices. Chinnappa Reddy, J in his separate judgment emphasized the need to depart from the principle laid down in *Duke of Westminster* and held that the proper way to construe a taxing statute while considering a device to avoid tax is not to ask whether a transaction is not unreal or not prohibited by the statute but whether the transaction is a device to avoid tax and whether the judicial process will accord its approval to it. The difference in the approaches of the two Judges is clear. The rule laid down by Chinnappa Reddy, J is much wider and seeks to prohibit all devices to avoid tax, including those that fall within the legal framework. The confusion with respect to interpreting the judgment arises due to a sentence in which Ranganath Mishra, J after asserting that tax planning within the legal framework is not prohibited, states that Chinnappa Reddy, J has proposed a separate opinion with which the remaining judges agree.

The next stage of development in the position of law came in the decision of a Division Bench of the Supreme Court in *Union of India & Anr. v Azadi Bachao Andolan and Anr.* The Division Bench observed that Chinnappa Reddy, J proceeded on the assumption that the principle in *Duke of Westminster* had been departed from by the House of Lords in *Ramsay*. The Bench then went on to recount inter alia the case of *Craven v White* where it was held that it is not a part of the judicial function to treat as nugatory any step whatever which a taxpayer may take with a view to the avoidance or mitigation of tax. Ultimately, the Division Bench held that it was unable to agree with the view that the principle in *Duke of Westminster* is dead and that the observations of Shah, J in *CIT v Raman* are very relevant today. Further, the Bench also mentioned the decision of the Madras High Court in *M. V. Vallipapan & Ors v ITO* where it was explicitly held that the decision in *McDowell* cannot be read as laying down that every attempt at tax planning is illegitimate and must be ignored.

However, an interesting controversy surfaced regarding the observation of the Division Bench in *Azadi Bachao Andolan*. Critics questioned how the Division Bench could detract from the observations of the Constitutional Bench of the Supreme Court in *McDowell* given that Ranganath Mishra, J in the latter case explicitly stated that the judges whom he was speaking for agreed with the separate judgment of Chinnappa Reddy, J on tax avoidance. They argued that *Azadi Bachao Andolan* was decided *per incuriam* since the Constitutional Bench’s decision was binding on the Division Bench. It appears however, that a recent decision of the Bombay High Court prevents this anomaly from being exploited. The Court held that the ratio of *McDowell* as understood by the Supreme Court in *Azadi Bachao - Andolan* is the law, considering that this was the manner in which the Supreme Court understood the ratio decidendi of the judgment in *McDowell*.

Some commentators are of the opinion that the Supreme Court in *Azadi Bachao Andolan* did not move away from the substance over form principle laid down in *McDowell*. They argue that the Supreme Court even in the case of *Azadi Bachao Andolan* held that substance in the transaction is the key for tax purposes. However, the Court was quick to declare a transaction which was otherwise in accordance with the law would receive the blessings from the perspective of tax laws even if the transactions was designed exclusively for tax saving purposes. Accordingly, the Revenue was precluded from questioning the commercial necessity or justification of a transaction provided that such transactions was not
colourable or prohibited by law.49

VI. Direct Taxes Code and GAAR

The Direct Tax Code (DTC) Bill which was released for public comment on August 12, 2009 was introduced in the Lok Sabha on August 30, 2010 to consolidate and amend the law relating to direct taxes with a view to establish an economically efficient and equitable direct tax system. Primarily, it aspires to reduce the scope for litigation by avoiding ambiguity in provisions which invariably give rise to rival interpretations. As per the 2009 Discussion Paper, the objective is that the tax administrator and the taxpayer are ad idem on the provision of law.50 This section analyzes the impact of the DTC on the doctrine of piercing the corporate veil. Towards this, an attempt is made to discuss provisions in the DTC which suggest the application of the doctrine.

To begin with, the 2009 Discussion Paper expresses the need for a General Anti-Avoidance Rule (GAAR) on grounds that tax avoidance seriously undermines the achievements of public finance of collective revenue in an equitable manner and that increasingly sophisticated forms of tax avoidance have led to a serious erosion of the tax base. The Discussion Paper also cites as a reason for the introduction of a GAAR, the heavy onus placed on the Revenue by the Appellate authorities and the Courts when dealing with matters of tax avoidance notwithstanding that the relevant facts are in the exclusive knowledge of the taxpayer who may choose not to reveal them.51 The Revised Discussion Paper of 2010 (RDP) also makes reference to these grounds.52 Thus the government felt the need to introduce a general statutory rule to check tax avoidance as opposed to repeatedly amending the statute to deal with specific instances of avoidance.

The General Anti-Avoidance Rule

The GAAR appears in section 123 under Chapter XI (Part F) of the DTC relating to Special Provisions to Prevent Evasion. The text of s. 123 provides that any arrangement entered into by a person may be declared as an impermissible avoidance arrangement. Further it is provided that the consequences of such an arrangement may be determined inter alia by disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement, treating the impermissible avoidance arrangement as if it had not been carried out or in any other manner that the Commissioner deems fit in the circumstances of the case to prevent the accrual of any tax benefit, apart from re-allocating any accrual, receipt, expenditure, deduction or rebate among the parties and re-characterizing any equity (into debt), accrual, receipt, expenditure, deduction, relief or rebate.53

Extracts from the Interpretation Clause

Section 124 provides the interpretation clause for Part F of the DTC. As per s. 124(15), “impermissible avoidance arrangement” means a step in, or a part or whole of, an arrangement whose main purpose is to obtain a tax benefit in a manner such that it creates rights and obligations which would normally not be created between persons dealing at arm’s length; it results directly or indirectly in the misuse or abuse of the provisions of this Code; it lacks commercial substance in whole or part; and is entered into or carried out, by means or in a manner, which would not normally be employed

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for *bona fide* purposes. The term arrangement is defined u/s. 124(3) of the DTC. An arrangement means any step in, or a part or whole of, any transaction, scheme, agreement or understanding, whether enforceable or not, and includes such transactions, schemes, agreements or understandings that involve the alienation of property. The definition of “tax benefit” under the DTC includes a reduction, avoidance or deferral of tax or other amount payable under the DTC, an increase in the refund of tax or other amount under the DTC, a reduction, avoidance or deferral of tax or other amount which would have been payable but for a tax treaty, and an increase in refund of tax or other amount as a result of a tax treaty.

The proceeding discussion reveals that the tax authorities can marshal the GAAR into the picture only if they can detect an impermissible avoidance arrangement. This requires that the arrangement is structured in a manner that covers any of the four conditions given u/s. 124(15) of the DTC and which will cause tax benefits to accrue. The RDP was quick to clarify that the proposed GAAR provisions do not envisage that every arrangement for tax mitigation would be classified as an impermissible avoidance arrangement. Only those transactions which are calculated to derive a tax benefit and which are not at arm's length or misuse or abuse the provisions of the DTC or lack commercial substance or are entered into for purposes that are not *bona fide* come within the ambit of impermissible avoidance arrangement. Here, it must be made abundantly clear that transactions deriving tax benefits other than those transactions deriving tax benefits which are also covered by one of the aforementioned conditions would not be classified as being impermissible avoidance arrangements.

Here it is critical to note that the RDP has proposed certain safeguards relating to the invoking of the GAAR. As per the RDP, the CBDT will issue guidelines to provide for circumstances under which the GAAR may be invoked. Additionally, the RDP states that the GAAR will only be applied where avoidance exceeds a specified threshold limit and also extends the forum of the Dispute Resolution Board in cases where the GAAR is invoked.

**Arrangements lacking commercial substance**

A key feature of this discussion is the meaning of the phrase “lacks commercial substance”. Under the DTC, the Commissioner is empowered to apply the GAAR when a transaction lacks commercial substance thereby constituting an impermissible avoidance arrangement. As per s. 124(19) of the DTC, any step in or a part or whole of an arrangement shall be deemed to lack commercial substance if it would result in any tax benefit for any party to the arrangement but does not have a significant effect on business risk or net cash flows or if the legal substance or effect of an arrangement differs significantly from the legal form of its individual steps or if it includes or involves round trip financing, an accommodating or tax indifferent party, any elements that have the effect of offsetting or cancelling each other or a transaction which is conducted through one or more person and which disguises the nature, location, source, ownership or control of the fund.

The DTC appears to have drawn from the tussle between commercial expediency and commercial substance that was reflected respectively in the cases of McDowell and Azadi.
Bachao Andolan and appears to have statutorily settled the debate in favour of commercial substance. The language employed in the DTC for defining commercial substance or the lack of it is extremely wide and could potentially include any commercial transaction. In fact, the GAAR firmly incorporates the substance over form test, the economic substance test and the effects doctrine, besides permitting controlled foreign corporation (CFC) rules and thin capitalisation rules. It may be well to briefly dwell upon the concepts of thin capitalisation rules and CFC rules and understand how the GAAR may be applied in these cases. Arguably, applying the GAAR in matters of thin capitalization or CFC does not represent a case of ‘piercing the corporate veil’ in the true sense. However it serves the purpose of illustrating the wide amplitude of the GAAR.

Thin Capitalisation

Finance Ministry officials have stated that thin capitalisation rules could come under the GAAR. Thin capitalisation refers to a situation where a company is characterized by a high proportion of debt-capital. Companies adopted loan financing with a view to obtain a tax benefit. The interest paid on loans is tax-free and increasingly, companies had begun using this as a tax saving instrument. In response to this, the Government seeks to apply the GAAR to re-characterize debt as equity if such an arrangement constitutes an impermissible avoidance arrangement under the DTC.

Controlled Foreign Corporations

The term Controlled Foreign Corporation (CFC) is a legal construct which describes a corporation that is established in one jurisdiction but is owned or controlled primarily by the shareholders of another jurisdiction. In the Indian context, it would therefore refer to a foreign company whose majority stake is held by Indian shareholders. By virtue of the fact that majority shareholders of such a foreign company reside in a different jurisdiction i.e. India, the payment of dividends by the company causes income to accrue among resident Indians. At this juncture, there has been a tendency among foreign companies controlled by resident Indian shareholders to defer payment of dividends and other profits. The DTC introduced CFC provisions so as to ensure that undistributed passive income earned by a foreign company owned directly or indirectly by an Indian resident resulting in deferral of taxes is deemed to be distributed. Deferral of tax payment is considered a tax benefit under the DTC and where such tax benefit is the primary consequence of an impermissible avoidance arrangement, the GAAR is attracted.

The DTC Concept of Residence

The DTC combines the concepts of residence-based taxation and source-based taxation. According to the former, natural persons and individuals are taxable in the country in which they set up their domicile. The original draft of the DTC and the 2009 Discussion Paper advocated a residence regime wherein company would be treated as a resident in India if its place of control and management was situated partly or wholly in India at any time in the year. After much apprehension and following the recommendations of the RDP, the second draft of the DTC adopted the internationally recognized standard of “place of effective management” to determine residence in India. The Interpretation Clause given u/s. 314(192) of the DTC defines “place of effective management” as the place where the Board of Directors or its executive directors make their decisions or the
place where the executive directors make strategic and commercial decisions which are routinely approved by the Board.68

**Treaty Override Clause**

The 2009 Discussion Paper explains the basis for having provisions which override the provisions of tax treaties. India has been a signatory to a number of Double Taxation Avoidance Agreements (DTAA). As per the Vienna Convention, a treaty must be interpreted in good faith and in light of its object and purpose.69 The Discussion Paper says that where any international agreement results in unintended consequences such as tax evasion or flow of benefits to unintended persons, it is open to the signatory to take corrective steps to prevent the abuse of the treaty. This position is further reinforced by the OECD Commentary on Article 1 of the Model Tax Treaty which clarifies that a general anti-abuse provision in the domestic law which incorporates the doctrines of “substance over form” or “economic substance” is not in conflict with any treaty. Under such circumstances, the DTC will override the treaty.70

The position under the Income Tax Act, 1961 is that the taxpayer has a right to choose between the provisions of the Act and the provisions of the treaty whichever is more beneficial to him. The 2009 Discussion Paper stated that neither the DTAA nor the DTC would have a preferential status. However, in the case of conflict between the DTC and a DTAA, the one that is later in point of time will prevail.71 Following a number of apprehensions, the RDP clarified that the position under the Income Tax Act will be followed and that the taxpayer may choose the more beneficial between the Treaty and the Code except when the GAAR is invoked, when CFC provisions are invoked or when Branch Profits Tax is levied.72 Accordingly, s. 291(8) of the DTC provides that provisions of the DTC shall apply to the extent that they are more beneficial to the taxpayer except in relation to GAAR u/s. 123, levy of Branch Profits Tax u/s. 111 and CFC Rules under the Twentieth Schedule.73

**Presumption of purpose**

Under the DTC, an arrangement shall be presumed to have been entered into or carried out for the main purpose of obtaining a tax benefit unless the person obtaining the tax benefit proves that obtaining the tax benefit was not the main purpose of the arrangement. Similarly, an arrangement shall be presumed to have been entered into, or carried out for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or part of the arrangement is to obtain a tax benefit, regardless of the fact that the main purpose of the whole arrangement may not be to obtain a tax benefit.74 This provision is certainly inspired from the experience under the Income Tax Act regime where the tax authorities are severely disadvantaged in terms of establishing sham transactions. Moreover, the RDP is quick to defend the GAAR on grounds of there being no significant additional information and disclosure requirements for taxpayers.75

**DTC Regime and Piercing the Corporate Veil**

Before we conclude our discussion on the DTC, it would be prudent for the purpose of clarity, to highlight the connection between the GAAR and the doctrine of piercing the corporate veil. The doctrine emerged from the judiciary as a means of unearthing sham transactions and ensuring that proceeds from such transactions were charged to tax.
The judicial doctrine came to acquire certain standards on the basis of which transactions would be classified as colourable transactions but the judicial doctrine despite all its developments could not fathom all the possible devices employed to avoid tax. The GAAR emerged in this context as a widely worded statutory rule that could be used to potentially bring any transaction under its scanner. More importantly, the GAAR shifts the standard from ‘transaction’ to ‘arrangement’ thereby increasing the scope of its own coverage. The definitions of “impermissible avoidance arrangement”, “tax benefit” and “lacks commercial substance” etc. were discussed with a view to demonstrate the proposed functioning of the GAAR regime when it comes into effect. Our preliminary analysis is that the GAAR regime along with its treaty override clause and presumption of purpose clause will serve the Government’s objective of ensuring compliance as well as checking tax avoidance well.

VII. Law in Other Jurisdictions

Before we part with this discussion, it might be well to consider the position of law in other jurisdictions. The debate about whether a transaction or arrangement should be analyzed for tax purposes on the basis of its legal form or, alternatively, its economic substance has raged across jurisdictions. One would remember our discussion on the development of the position in UK in an earlier section. Most jurisdictions have settled this debate in favour of substance over form.

Australia

Australia has incorporated both general and specific anti-avoidance rules in its income tax legislations. These rules have been designed to prevent inappropriate fiscal outcomes arising where tax payers have deliberately altered the form of their transactions in order to obtain a fiscal advantage. The general anti-avoidance provisions under Part IVA of Australian Income Tax law (the Income Tax Assessment Act, 1936), to some degree provides scope for the authorities to adopt a ‘substance over form’ approach in relation to arrangements entered into by taxpayers with the dominant purpose of reducing their income tax obligations. An Australian Tax Office Draft Determination (TD 2009/17 – Income tax: treaty shopping) that was issued following the case of Federal Commissioner of Taxation vs. The Myer Emporium Ltd.76 is indicative of the manner in which the Australian authorities have adopted the substance over form approach.77

United States

The US has several rules in its legislation which have codified the substance over form concept. The Internal Revenue Service (IRS) is permitted to re-characterize cross-border conduit financing transactions. Specifically, the IRS is authorized to disregard an intermediate company in a multiparty financing agreement if the company is used as part of tax avoidance plan. The US courts have consistently taken the view that transactions are to be taxed according to their economic substance rather than their legal form.78 Furthermore, in Burger King v State Tax Commission,79 the Court overlooking the form of the transaction, rejected the contention of the Tax Commission that Burger King could not claim exemption from sales tax because it did not charge a line item on the receipt for packaging and hence the packaging was not
being resold. Most importantly, the Supreme Court, in Helvering v F & R Lazarus & Co,\textsuperscript{80} summarized the doctrine of the substance over form by stating that administrators of the law and the courts are concerned with substance and realities. The Court further stated that formal written documents are not rigidly binding.\textsuperscript{81}

**Germany**

German law recognizes the substance over form approach in those instances where an inappropriate legal structure resulting in tax advantage is utilized and where the taxpayer is unable to provide significant non-tax reasons for using such a structure. A legal structure is considered inappropriate if the taxpayer or a third party generates a tax benefit that is not intended by the law.\textsuperscript{82} Here, it is interesting to note that the onus on establishing the *bona fide* of a legal structure resulting in tax advantage lies with the taxpayer. In this way, there is a similarity between German law and the presumption of purpose clause u/s. 125 of the DTC.

**Switzerland**

Switzerland does not have many written or specific anti-avoidance rules. Under such circumstances, the general principles of abuse of law or tax evasion apply. Swiss law does not look unfavourably upon aggressive tax planning efforts provided such efforts do not result in abuse of law or tax evasion. However, Swiss law does recognize the substance over form approach. Swiss tax authorities are empowered to disregard a structure or transaction and assess tax liability on the basis of economic realities underlying the transaction in circumstances where the form chosen by the taxpayer is unusual, where the form has been chosen only for tax saving purposes and where the taxpayer would make significant tax savings if the hypothesis in which the structure was recognized by the tax authorities.\textsuperscript{83}

**VIII. Suggestions**

This portion of the paper will focus on two questions viz. whether the law requires to be reformed and what reforms can be suggested? In dealing with these questions, we are in the unenviable position of having to balance the interests of the taxpayer and the Revenue. The Direct Taxes Code is expected to take effect in April 2012 and accordingly, this section will focus on the principles relating to ‘piercing the corporate veil’ that have been enshrined in the DTC. We answer the first question by affirming that the law requires to be reformed in the interests of clarity. The Government has undoubtedly made an ideological choice in revising the tax regime in favour of the Revenue and we intend to confine our suggestions within the framework of this choice. The following paragraphs answer the second question.

**Safeguards in the application of GAAR**

The RDP states that the CBDT will issue guidelines for the circumstances in which the GAAR may be invoked. At the time of the Bill being introduced in Parliament, no additional guidelines have been introduced. The apprehension was that legitimate tax planning efforts may be undermined.\textsuperscript{84} The Revenue may evolve a strategy wherein it targets a particular pattern of business structures that results in high losses to the
Exchequer. In other words, the CBDT which has the power to issue guidelines can outline particular avoidance models or arrangements which will be targeted by the GAAR so as to ensure greater clarity for the tax authorities and the taxpayer.

**Tax Benefits and Impermissible Avoidance Arrangements**

The premise of an ‘impermissible avoidance arrangement’ is that there is an arrangement which in whole or part, or any step therein, has as its main purpose the obtaining of a tax benefit. Similarly, a tax benefit refers to a reduction, avoidance or deferral of tax payable. It is difficult to fathom any arrangement which is established for even bona fide purposes which may not have the effect of resulting in tax avoidance or reduction. In other words, the DTC which was designed to target tax avoidance can potentially target legitimate arrangements. This is a genuine concern and demands that the language of GAAR regime be reconsidered.

**Focus on ‘impermissible arrangement’**

Greater clarity is achieved if the statute is seen in terms of tax avoidance being an incidence of an impermissible avoidance arrangement. Ideally, the tax authorities should probe arrangements that fall under any one of the four grounds under s. 124(15) of the DTC and then ascertain whether such an arrangement has resulted in any tax benefit. No harm is caused where an impermissible arrangement does not result in loss to the exchequer. An impermissible arrangement in itself is not a bona fide arrangement under the DTC. Consequently, a resulting tax benefit should trigger the GAAR regardless of whether or not such tax benefit was the main purpose behind the arrangement. Accordingly, we suggest that the words “whose main purpose is to obtain” in s. 124(15) of the DTC be replaced by the words “resulting in”.

**IX. Concluding Remarks**

There are no two ways about assessing the doctrine of piercing the corporate veil. It has proved to be an effective instrument in unearthing sham transactions and recovering losses to the exchequer. The legislature was spot on in measuring the utility of the doctrine and giving it statutory recognition in the Direct Taxes Code in the form of the anti-avoidance rule. The doctrine has witnessed phenomenal transformation from the time when Indian courts first applied it to taxation matters to the time when the DTC was introduced in the Parliament. Following the decision in Azadi, it came to be accepted that the Indian tax regime allowed taxpayers to arrange their finances in a manner that would result in least tax liability provided such arrangement was legal. The decisions in Vodafone and Richer Holding have demonstrated how the doctrine was applied to bring seemingly immune transactions within the tax ambit.

A new tax regime, the DTC, is expected to be introduced in India. The language of the DTC discloses an unmistakable intention to clamp down on any avoidance structure that is impermissible. The taxman has been blessed with the powers of the GAAR – a widely worded statutory provision which allows an investigation into the economic substance of any arrangement. In this manner, the DTC has
also settled the substance versus form debate profoundly in favour of the former. Furthermore, the DTC mandates a presumption that an arrangement is designed to avoid tax and requires the taxpayer to explain otherwise.

Despite this, there were some aspects of the DTC that required clarification. We suggested that the tax authorities focus its efforts on assailing specific avoidance models and provide clear guidelines in this regard. We were also took note of the numerous definitions under the anti-avoidance Chapter and were concerned about whether legitimate arrangement would unnecessarily attract anti-avoidance measures. Finally, we suggested that the GAAR be applied to any impermissible arrangement that resulted in loss to the exchequer as opposed to trying to determine whether tax avoidance was the main purpose of the arrangement.

The doctrine of piercing the corporate veil has taken up a new avatar in the form of the GAAR. This is the first time the Indian tax regime has unambiguously adopted a substance over form approach and the performance of this approach will be keenly watched. Introducing the GAAR takes India into the league of several other tax jurisdictions which have used an anti-avoidance rule. The GAAR was intended to deter defaulters and improve compliance. It will be interesting to track these statistics. At a different level, it will also be interesting to see whether the new tax regime adversely affects the foreign investment climate.

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Articles


get-ready-for-gaar-in-dtc-2010/.


• The Economic Times, *Finmin probing more than 100 overseas deal for tax evasion*, Dec. 13, 2010

**Books**


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3 Ibid.


5 [1897] A.C. 22. The House of Lords laid down that “The company is at law a different person altogether from the subscribers to the Memorandum […] Nor are subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.”

6 (1933) Gh. 935. Lord Hanworth M.R. observed that “The defendant company was the channel through which the defendant Horne was carrying on his business.”
7 (1988) 4 SCC 59. The Court held that where the Renusagar plant was brought into existence by Hindalco to fulfil the conditions of industrial license, to avoid complications relating to take over of the power station by the State or Electricity Board and where Renusagar was a wholly-owned subsidiary of Hindalco, that the corporate veil should be lifted and Hindalco and Renusagar be treated as one concern.

8 (1964) 6 SCR 895.

9 (1985) 4 SCC 19. The Court held that where a partner transferred his shares as capital contribution to the partnership firm, he received no consideration within the meaning of s. 48 of the Income Tax Act, 1961, nor did any profit or gain accrue to him u/s. 45 of the Act.

10 [1967] 1 SCR 934. The Court held that where the Director of the assessee-companies was also the Director of the Bank which issued loans to the companies in non-taxable territory and then moved the money to taxable territories, the knowledge of the Director with respect to the particulars of this arrangement will be imputed to the companies.

11 (1986) 1 SCC 264

12 AIR 1999 Cal 106, also followed in Avas Vikas Sansthan Engineering Association and Ors. v. Avas Vikas Sansthan and Ors. 2000 (4) WLC 647 (Raj) and Gwalior Citizen Sakh Sahakarita Mariyadit vs. Union of India [2011] 333 ITR 196.


14 (1985) 47 CTR (SC) 126

15 (1969) 73 ITR 702 (SC)

16 (1987) 164 ITR 28

17 The Commissioner of Income Tax (Central) v. Rockman Cycles Industries Private Ltd. (2011) 238 CTR (P&H) 363

18 Commissioner of Income Tax v. Sri Mukesh Luthra & Ors. 2011 VAD (Delhi) 647


20 [2002] 256 ITR 563 (Delhi). The impugned circular validated circulars issued by Mauritian authorities as to the genuineness of certain businesses entities situated in Mauritius.

21 (2004) 10 SCC 1

22 The Supreme Court accepted that certificates issued by the Mauritian authorities were sufficient proof of the genuineness of the business concern.

The Economic Times, Finmin probing more than 100 overseas deal for tax evasion, Dec. 13, 2010

See s. 9(1) of the Income Tax Act, 1961 which provides that income is deemed to accrue or arise in India directly or indirectly through the transfer of a capital asset situated in India.


Vodafone International Holdings B.V v Union of India and Anr. [2010] 193 TAXMAN 100 (Bom).

Richter Holding Limited v The Asst Director of Income-Tax, The Deputy Director of Income-Tax and Union of India – I, [2011] 199 TAXMAN 70 (Kar)

The Revenue contended that the above transaction resulted in a transfer of capital assets which is liable to capital gains tax u/s. 45 r/w s. 2(47) r/w s. 9 of the Act.

Richter Holding Limited v. The Asst Director of Income-Tax, The Deputy Director of Income-Tax and Union of India – II. Decided on 13.06.2011

(1935) All ER 259.

The Duke executed deeds in favour of his employees such that those persons who had left the Duke’s service were not expected to exercise their claim over wages. The House of Lords observed that to regard payments under the deed as in-effect payments of salary would be to treat a transaction of one legal character as if it were a transaction of a different legal character.

(1946) 30 TC 11.

1982 AC 300.

(1982) STC 30. 36 In Burmah, the Court held that a series of circular payments which left the taxpayer company in exactly the same financial position as before was not regarded as giving rise to a “loss”.

(1984) 1 All ER 530

In Furniss, the transfer of shares to a subsidiary as part of a planned scheme to transfer them immediately to an outside purchaser was regarded as a taxable disposition to the outside purchaser rather than an exempt transfer to a group company.


The following principles on tax planning are embedded in Indian tax jurisprudence:

1) A transaction or arrangement which is permissible under law and has the effect of reducing the tax burden does not incur the wrath of the law.

2) Citizens and business entities are entitled to structure or plan their affairs with circumspection and within the framework of the law.

3) A sham transaction is one in which the parties ostensibly seek to clothe the transaction with legal form but actually engage in a different transaction altogether.

4) Barring sham transactions, assessees are entitled to structure their businesses through the instrument of genuine legal frameworks.


Ibid.


See s. 123 of the DTC.

See s. 124 of the DTC.

See s. 124(25) of the DTC.

Supra Note 52.

Supra Note 52.
58 See s. 124(21) of the DTC.
59 See s. 124(19) of the DTC.
64 Supra Note 52.
65 Supra Note 50.
66 Supra Note 52.
67 See s. 4(3) of the DTC.
68 See s. 314(192) of the DTC.
70 Supra Note 50.
71 Ibid.
72 Supra Note 52.
73 See ss. 291(8) and 291(9) of the DTC.
74 See s. 125 of the DTC.
75 Supra Note 52.
76 (1987) 163 CLR 199. Where a Caymen Islands registered investment fund held an interest in Myer indirectly through a Luxembourg company, which in turn held all the shares in a Dutch company, the Australian Authorities were of the view that there was no significant commercial activity by the Dutch company and that it was set up with the purpose of sheltering disposal gains from Australian tax under the Australian-Dutch Tax Treaty. Accordingly, this arrangement was disregarded.

78 Goldstein v Commissioner 364 F. 2d 734. Also see Frank Lyon Co. v United States [78-1 USTC 9370] (1978)


80 308 U.S. 252 (1939).


82 Ibid.


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