USE OF THE CORPORATE VEHICLE FOR TAX PLANNING: THE *VODAFONE* CASE AND DIRECT TAXES CODE

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*The use of corporate entity in tax planning is permissible as long as it is not used as a colourable device. The **Vodafone judgment** in 2009 applied lax standards to lift the corporate veil. If the tax claim eventually becomes successful, it can make any tax planning involving a corporate entity difficult. From provisions related to General Anti-Avoidance Rule, residence of a foreign company, Controlled Foreign Corporations and Double Tax Avoidance Agreements under the proposed Direct Taxes Code, it can be inferred that the use of a corporate vehicle for tax planning shall become more difficult when it comes into application, and may have uncertain results. Although the ruling of the Authority for Advanced Rulings in **E*Trade** in the same year is favourable towards using corporate entity for tax planning, it does not set a precedent and is binding only on the parties involved. Thus, the paper suggests a cautious approach in using a corporate entity for tax planning.*

I. INTRODUCTION

Planning is the formulation of a system which in its implementation is designed to achieve a specific result.[1] While economic planning is the privilege of the State, tax planning is that of the subject.[2] In general, tax planning aims to reduce the outflow of cash resources made available to the government by way of taxes so that the same may be effectively utilized for the benefit of the individual or the business, as the case may be.[3] It involves arranging one's financial affairs by intelligently anticipating the effects of tax laws on the arrangements that have been adopted.[4] This paper indicates how under the existing and proposed taxation

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1 INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA, DIRECT TAX LAWS, VOLUME 1, 14.1.

2 *Id.*

3 *Id.,* 14.2.

4 *Id.*

regime in India, tax planning has become more difficult. Part II discusses the contours of tax planning. Part III outlines the law relating to the lifting of the corporate veil and shows how the recent judgment in *Vodafone International Holdings BV* v. *Union of India* lifted the corporate veil without applying the settled prerequisites under the Indian law. Part IV mentions how provisions related to General Anti-Avoidance Rule, residence of a foreign company, Controlled Foreign Corporations and Double Tax Avoidance Agreements under the proposed Direct Taxes Code can make tax planning more difficult.

II. LEGITIMACY OF TAX PLANNING

Way back in 1936, the Appellate Court in *IRC* v. *Duke of Westminster*[5] held that a citizen has the legal right to dispose of his capital and income so as to attract upon himself the least amount of tax. Avoidance of tax is not evasion and carries no ignominy. It was observed that *"given a document of transaction is genuine the court cannot go behind it to some supposed underlying substance"*.[6]

The Westminster principle is followed in India.[7] The five judge bench judgment of the Supreme Court in *McDowell* v. *CTO*[8] (*McDowell*) is perceived to have changed this fiscal jurisprudence of the country. It is perceived that any tax planning which results in tax avoidance is invalid in the light of *McDowell*. It is difficult to appreciate these perceptions for the following reasons: Firstly, even in *McDowell*, Justice Ranganath Mishra, speaking for himself and three other judges, confirmed the legitimacy of tax planning within the contours of law. He observed that *"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. "* The rest of the judges, other

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[5] IRC v. Duke of Westminster, [1935] All ER 259 (H.L.).

[6] *W. T. Ramsay* v. *Inland Revenue Commissioners* [[1982] AC 300] was a significant departure from the *Westminster principle.* In the instant case, the House of Lords considered a tax avoidance scheme which consisted of a series or a combination of transactions each of which was individually genuine but all of which as a whole resulted in tax avoidance. The House laid the principle that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole. It is not to be ascertained by dissecting the scheme and considering each individual transaction separately. The dictum in Ramsay was echoed in *Inland Revenue Commissioners* v. *Burmah Oil Co. Ltd* [[1982] S.T.C. 30, H.L.(Sc.)] and *Furniss* v. *Dawson* [(1984) 1 All ER 530] However, the legality of *Westminster principle* was re-affirmed in subsequent cases such as *Craven* v. *White* [(1988) 3 All ER 495] and *Mac Niven (Inspector of Taxes)* v. *Westmorland Investments Ltd* [(2001) 1 All ER 865] .

[7] In *CIT* v. *A. Raman & Co.* [(1968) 67 ITR 11] the Supreme Court held that the avoidance of tax liability is not prohibited. A taxpayer may resort to a device to divert the income before it accrues to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income Tax Act. Legislative injunction in taxation statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented.

[8] McDowell v. CTO, AIR 1986 SC 649.

than Justice Chinnappa Reddy, did not ascribe to the idea that tax avoidance was illegitimate in itself. Secondly, the reasoning of Justice Chinnappa Reddy that the British courts had disassociated themselves from the Westminster principle was flawed. On the contrary, three years after *McDowell* was pronounced, the House of Lords upheld the legality of Westminster principle after analysing the very same trilogy of cases that Justice Chinnappa Reddy had relied upon.[9] This position was vindicated as recently as in 2001.[10]

In *Union of India* v. *Azadi Bachao Andolan*[11] (*Azadi Bachao Andolan*), it was argued that any tax planning which results in avoidance must be struck down in the light of *McDowell*. Rejecting this argument, the court upheld the legitimacy of tax planning.[12] The Court observed that the *McDowell* judgment was nothing exceptional but only an exception to the well-settled law. In *Shiv Kant Jha* v. *Union of India*[13] a review petition was filed against *Azadi Bachao Andolan* judgment. The petition was dismissed. A curative petition was also dismissed.

The following conclusions can be drawn from this discussion:

a) Tax planning is an entitlement of the assessee within the contours of law.
b) Any genuine attempt to plan the financial and economic affairs should not be discouraged merely by taking shelter under *McDowell's* judgment.
c) Tax incentives availed of by an assessee should be within the ambit of legitimate tax planning.
d) Tax planning should not involve use of colourable devices for reducing tax liability.

Accordingly, use of corporate entity in tax planning is legally valid provided its use is within the contours of the above mentioned conclusions. However, we shall argue for a cautious approach vis-à-vis use of corporate entity in tax planning for the following reasons:

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[9] Craven v. White, (1988) 3 All ER 495.

[10] Mac Niven (Inspector of Taxes) v. West Morland Investments Ltd., (2001) 1 All ER 865.

[11] Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 707 (SC).

[12] The Apex court referred to the Privy Council judgment in *Bank of Chettinad Ltd* v. *CIT* [(1940) 8 ITR 522 PC] which accepted the principle laid down in *Duke of Westminster.* The judgment was the law when the Constitution came into force. The legal position continues by virtue of Article 372 by which all laws in force in the territory of India immediately before the commencement of the Constitution shall continue in force until altered or repealed or amended by a competent Legislature or other competent authority. Hence the principle laid down in the *Westminster case* is still applicable unless reversed by a Supreme Court verdict or an Act of Parliament. The Court observed as follows: *"We are unable to agree with the submission that an act which is otherwise valid in law can be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents."*

[13] Review Petition (Civil) No. 1917-1918/2003 & Curative Petition No. 10569/2004.

a) The Bombay High Court judgment in *Vodafone* case (2009), though only of academic importance, has distanced itself from the existing fiscal jurisprudence which includes *McDowell* and *Azadi Bachao Andolan* judgments. In this case, the corporate veil was lifted eventhough it was not proved to be a colourable device. This reasoning can frustrate any attempt in using a corporate entity for tax planning.

b) The Direct Taxes Code, even in the aftermath of Revised Discussion Paper, may make any tax planning involving corporate entities difficult. Rather than imparting certainty which is one of the stated objectives, if implemented along proposed lines, tax implications will become unpredictable.

III. *VODAFONE CASE* IN A NUTSHELL

In *Vodafone International Holdings BV* v. *Union of India,*[14] Hutchinson International (non-resident company) held 100% shares of CGP Investments Holdings Ltd. (non-resident company) which in turn held 67% shares in the Indian company Hutchinson-Essar. Hutchinson-Essar was a joint venture between Hutchinson International and Essar. Vodafone International Holdings BV (non-resident company) acquired the entire share capital of CGP Investments Holdings Ltd. from Hutchison International. This resulted in an indirect transfer of 67% shareholding in Hutchinson-Essar to Vodafone.

The question which arose was, whether the income accruing to Hutchinson as a result of the transaction could be deemed to accrue or arise in India by virtue of § 9 of the Income Tax Act. The Income Tax Department issued Vodafone a show cause notice asking why action should not be taken against it for failing to deduct tax at source under § 195 of the IT Act while making payment of the consideration to Hutch. The validity of the show-cause notice was challenged by Vodafone in a writ petition before the Bombay High Court. The High Court held that the writ petition challenging the show-cause notice was premature as an alternative remedy was available to the petitioner. Vodafone appealed in the Supreme Court. The petition was dismissed with a direction to re-agitate the jurisdictional issue before the assessing officer.[15]

In *Vodafone*, the High Court answered all issues against Vodafone. However, final and concrete conclusions cannot be drawn as the judgment was not dealing with the taxability of the transaction. The court was only considering the validity of the show-cause notice issued by the Department. Thus the judgment is more of an academic than of practical interest.

[14] Vodafone International Holdings BV v. Union of India (UOI), Ministry of Finance and Asst. Director of Income Tax (International Taxation), [2009] 311 ITR 46 (Bom).

[15] Vodafone International Holdings BV v. Union of India, [2009] 179 TAXMAN 129 (SC).

Though *Vodafone* involves various issues, this paper is limited to the issue of lifting the corporate veil and perusing the substance of the transaction in ignorance of its form. We shall argue that the *Vodafone* judgment lacks logic and coherence which are the essential ingredients of legal reasoning.

A. LIFTING THE CORPORATE VEIL

A company by virtue of its incorporation enjoys the advantage of a separate legal identity. It is an artificial person which is capable of enjoying rights and of being subject to duties which are not the same as those enjoyed by its members.[16] Thus personality of the company is separate from that of its members.[17] However, when the members of the company employ legal or corporate personality to serve an unjust and inequitable purpose or evade legal obligations, the courts refuse to maintain the separation. In such circumstances, the veil of incorporation is said to be lifted.[18] These circumstances are exceptions to the general rule of "separate legal personality" and not a rule.[19] The corporate veil indisputably can be pierced when the corporate personality is found to be opposed to justice, convenience and interest of the revenue of workman or against public interest.[20] It can be lifted when the purpose of the corporate entity is to evade tax or circumvent tax obligation.[21]

A corporate entity otherwise qualified should not be disregarded as a façade merely because it was purposely created and operated to gain tax benefits.[22] Thus, the form in which a transaction is entered into cannot be ignored. A complete disregard of the form is inconsistent with the existing fiscal jurisprudence. The doctrine of perusing the substance and not the form of the transaction, applies when there is a colourable or illegal transaction.[23] When the transaction itself is plain and unambiguous, the substance of the form cannot be perused.[24]

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16 GOWER AND DAVIES, PRINCIPLES OF MODERN COMPANY LAW 33 (1997).

17 Salomon v. A Salomon & Co. Ltd., [1897] AC 22, HL; In Guzdar v. CIT [AIR 1955 SC 74], it was held that there is nothing in Indian law that provides any basis whatsoever for the assumption that a shareholder who holds shares, holds any interest in the property of the company.

18 ALAN DIGNAM AND JOHN LOWRY, COMPANY LAW 30 (2008).

19 For instance, the Court of Appeal in *Adams* v. *Cape Industries Plc* [[1990] 2 W.L.R. 786, HL.], refused to lift the veil as against the defendant company on the ground that the right to use a corporate structure can be denied only in case of illegality and not immorality.

20 C.I.T., Madras v. Meenakshi Mills Ltd., (1967) 63 ITR 609 (SC); Workmen Employed in Assn. Rubber Industry Ltd., Bhavnagar v. Associated Rubber Industry Ltd., MANU/SC/0236/1985; Kapila Hingorani v. State of Bihar, (2003) 116 CompCas 133 (SC).

21 C.I.T., Madras v. Meenakshi Mills Ltd., (1967) 63 ITR 609 (SC); PALMER, COMPANY LAW 2223 (1992).

22 *Supra* note 11; Barber-Greene Americas Inc. v. Commissioner of Internal Revenue, (1960) 35 TC 365.

23 *Supra* note 8; *Supra* note 11.

24 CWT v. Arvind Narottam, (1988) 173 ITR 479.

In *Vodafone,* the High Court tried to lift the veil over the intermediary foreign company, holding that the transfer of shares of the intermediary company in fact amounted to the transfer of controlling interest in Hutchinson-Essar which is an Indian company. Interestingly, in response to a specific query from the High Court, the learned Additional Solicitor General categorically asserted that it was not the case of the respondents that the transaction entered into by Hutchinson and Vodafone was a colourable attempt to evade tax. It was also not contended that the corporate entity was abused for unjust and inequitable purposes. The Court lifted the corporate veil without any discussion on the fulfillment of these conditions, ignoring the principle that lifting the corporate veil is an exception and not a rule by itself.

The stream of reasoning in the *Vodafone* judgment lacks logic and coherence which are the essential ingredients of legal reasoning. The judgment completely disregarded the principles laid down in *McDowell* and *Azadi Bachao Andolan* judgments. It was not proved that the arrangement/transaction was a colourable device to bring down tax liability. This sets in a dangerous precedent which may jettison any tax planning involving a corporate entity. In this context, Advance Ruling Authority (*hereinafter* AAR) ruling in *E*Trade Mauritius Ltd.*[25] warrants attention.

The applicant, a resident of Mauritius, was a subsidiary of a USA company. It received capital contribution and loans from the USA parent which were used to purchase shares in ILFS, an Indian company. On the sale of shares, the applicant earned capital gains which were taxable under the IT Act. However, under Article 13 (4) of the India-Mauritius tax treaty, such gains were not taxable in India. The applicant filed an application for advance ruling on the question whether in view of Article 13 (4), the gains were chargeable to tax in India. The department resisted the application on the ground that though the legal ownership ostensibly vested with the applicant, the real and beneficial owner of the capital gains was the US Company which controlled the applicant. The applicant was merely a façade of the US holding Company to avoid capital gains tax in India. Rejecting the contention of the department and relying on *Azadi Bachao Andolan* judgment, it was held that there was no "legal taboo" against 'treaty shopping'.

It was held that the underlying objective of tax avoidance/mitigation cannot be equated to a colourable device. If a resident of a third country, in order to take advantage of a tax treaty sets up a conduit entity; the legal transactions entered into by that conduit entity cannot be declared invalid. The motive behind setting up such conduit companies is not material to judge the legality or validity of the transactions. However, a colourable device adopted through dishonest methods deserves perusal from the tax angle. Tax avoidance is not objectionable, if it is within the framework of law and not prohibited by law. However, a transaction which is 'sham' in the sense that 'the documents are not bona fide in order to intend to be

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[25] A.A.R. No.826 of 2009.

acted upon but are only used as a cloak to conceal a different transaction' stands on a different footing. An act is a 'sham' if the parties have a common intention not to create legal rights and obligations which they appear to create.

As all legal formalities for the purchase of the shares and their subsequent transfer had been completed, the assumption that the capital gain had not arisen in the hands of the applicant but had arisen in the hands of the USA parent did not hold ground. The fact that the holding company exercised control over its subsidiary did not, in the absence of compelling reasons, dilute the separate legal identity of the subsidiary. Thus, it was held that the India-Mauritius treaty benefits could not be denied on the ground that assessee was a subsidiary of US corporation.

On the other hand, in *Vodafone*, as mentioned earlier, the department did not even contend that the transaction was a 'sham' or a colourable attempt to avoid tax. Nor was there any attempt to characterize the transaction as an ambiguous transaction. For these reasons, the High Court should not have ignored the form of the transaction viz. selling shares of a company, by another company to a third company. The High Court, ignoring the legal form, held that the petitioner had *prima facie* acquired, apart from controlling interest, other interests and intangible rights from the transaction. The judgment, if it becomes final, can frustrate any tax planning involving a corporate entity as the corporate veil can be lifted at will in all impugned transactions.

IV. DIRECT TAXES CODE BILL, 2009

The Direct Taxes Code Bill (DTC) unveiled on August 12, 2009 envisages the creation of a robust tax system in India. It was expected to come into force on April 1, 2011, but was subsequently postponed to April 1, 2012. DTC seeks to consolidate and amend the existing direct tax law. One of the stated objectives is to establish an economically efficient, effective and equitable direct tax system which shall facilitate voluntary compliance and raise the tax-GDP ratio. It intends to reduce the scope for disputes and minimize litigation. According to the Discussion Ppaper (DP) on the draft, an attempt has been made to avoid ambiguity that invariably gives rise to rival interpretations. The objective is to bring assessor and assessee at *ad idem* on the provisions of law.[26] However, it is difficult to realise the above mentioned objectives in the light of the proposed incoherent framework in DTC.

We shall analyse the following aspects which shall make any use of corporate entity in tax planning difficult:

a) General Anti-Avoidance Rule
b) The concept of "residence" in case of a company incorporated outside India

[26] Discussion Paper on Direct Taxes Code, August 2009, Chapter–II, A-9.

c) Controlled Foreign Corporation provisions
d) Double Taxation Avoidance Agreement provisions

We shall argue that, rather than imparting certainty which is one of the stated objectives of DTC, if implemented along the proposed lines, DTC shall have unpredictable tax implications.

A. GENERAL ANTI-AVOIDANCE RULE

The DTC proposes to introduce General Anti-Avoidance Rule (GAAR) in the Indian tax legislation. The GAAR is a broad set of provisions which can invalidate an arrangement that has been entered into by a taxpayer with the main objective of obtaining a tax benefit. In addition, the DTC incorporates certain Specific Anti-Avoidance Rules (SAARs) to supplement GAAR for dealing with circumstances such as international transactions not at arms length.

GAAR is incorporated vide § 112 of the DTC to prevent tax avoidance. It perceives *all* forms of tax planning resulting in avoidances as inequitable and undesirable. DP echoes the above objective in these words: *"Tax avoidance, like tax evasion, seriously undermines the achievements of the public finance objective of collecting revenues in an efficient, equitable and effective manner. ...Therefore, there is a strong general presumption in the literature on tax policy that all tax avoidance, like tax evasion, is economically undesirable and inequitable. On considerations of economic efficiency and fiscal justice, a taxpayer should not be allowed to use legal constructions or transactions to violate horizontal equity."*[27]

GAAR applies to any "arrangement" if the same can be regarded as an "impermissible avoidance arrangement". The GAAR has defined an "arrangement" to mean any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes any of the foregoing involving the alienation of property. The expression "impermissible avoidance arrangement" has also been defined under § 113 (14) of the DTC to mean a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit and it:

i creates rights, or obligations, which would not normally be created between persons dealing at arm's length;
ii results, directly or indirectly, in the misuse, or abuse, of the provisions of the DTC;
iii lacks commercial substance, in whole or in part; or
iv is entered into, or carried out, by means, or in a manner, which would not normally be employed for bona fide purposes.

[27] *Id.*, Chapter XXIV, A-75 (emphasis supplied).

These definitions of "arrangement" and "impermissible avoidance arrangement" are broad enough to include even bona fide commercial transactions which are permissible in the light of *McDowell* and *Azadi Bachao Andolan* judgments. It is difficult to envisage a commercial transaction which does not fall within "a part or whole of any transaction, operation, scheme, agreement or understanding". Further, in the light of broad definition of "impermissible avoidance agreement", the use of corporate as a vehicle for tax planning is almost impossible. For instance, it may be difficult to prove "obtaining tax benefit" as *not* the "main purpose" especially when obtaining tax benefit is *one* of the purposes of corporate entity, even if it is an *incidental* purpose. Further, the creation of corporate entity necessarily involves creation of "rights or obligations" which can attract GAAR. Moreover, failure to prove cent percent "commercial substance" in a corporate entity which is used for tax planning can attract GAAR. In all these circumstances DTC allows lifting of corporate veil and perusing the substance of the transaction. It may be noted that the burden of proof is always on the assessee to prove otherwise.[28]

GAAR would apply to those transactions which the Commissioner presumes to be motivated by tax avoidance. The concerned commercial transaction shall be deemed to be for the main purpose of obtaining tax benefit. It has been left to the taxpayer to demonstrate otherwise.[29] The Commissioner has the powers to disregard, re-characterise or combine transactions at his will.[30] Effectively, the Commissioner can lift the corporate veil to ascertain the "substance" of the transaction as and when desired. Thus the broadly worded GAAR can allow the department to perceive a subsidiary as an agent or asset of the holding company at its will. This is a *clear* departure from the existing legal principles which have set a certain threshold for lifting the corporate veil[31]. This can result in unchecked scrutiny of any tax planning involving a subsidiary.

DTC provides that a transaction would fall outside the rule if it was carried out for commercial and economic reasons. However, considering the extensively worded provision and the discretion conferred upon the department, it is impossible for a corporate to satisfactorily pre-determine its tax liability till the completion of due diligence by revenue authorities.

The Revised Discussion Paper (RDP) on Direct Taxes Code which was released on 15th July, 2010, attempted to address some of these concerns. According

[28] Direct Taxes Code Bill, 2009, § 114.

[29] *Id.*

[30] *Id.*, § 112(1)(a).

[31] A subsidiary, for that matter even a cent percent subsidiary, is a separate legal entity. It cannot be held as an asset of the holding company. Also, agency cannot be presumed in case of non-resident company-subsidiary relationship. If one company is to be held liable as a principal for the acts of another company, the relationship of agency should be substantively established. Facts should reveal a *very high degree of control* by the parent over the subsidiary before a relationship of agency can be concluded.

to RDP, GAAR provisions do not envisage treating each and every arrangement as impermissible avoidance arrangements. The provisions shall be attracted only when the arrangement, besides obtaining tax benefit for the assessee, satisfies one of the four conditions as laid down in § 113 of DTC. The RDP proposed the following safeguards for invoking GAAR provisions:[32]

a) issue of guidelines by Central Board of Direct Taxes
b) invoking GAAR provisions in respect of an arrangement where tax avoidance is beyond a specified threshold limit
c) providing Dispute Resolution Panel for addressing grievances

Although the above proposals will bring in a certain degree of certainty in tax management, they are inapposite as far as building inherent checks and balances are concerned. For instance, RDP is silent on provisions regarding accountability (including certain minimum actions/ consequences) which can project an apposite sense of even handedness.

The proposals such as issue of guidelines and specifying threshold limit for tax avoidance will enable the department to unilaterally draw the contours of GAAR. Thus, contingent upon the language of guidelines and the specified threshold limit, any use of corporate vehicle for tax planning may attract GAAR provisions. Further, as the composition of Dispute Resolution Panel is unknown, it remains to be seen whether it will serve as an appropriate forum for adjudicating GAAR disputes.

B. THE CONCEPT OF RESIDENCE IN CASE OF A COMPANY INCORPORATED OUTSIDE INDIA

Under § 6(3) of the Income Tax Act, a foreign company shall be considered to be resident in India only if the "whole" of the control and management of its affairs are located in India. The DTC has widened the concept of residence. According to RDP, a company incorporated outside India will be treated as a resident in India and subjected to tax if its "place of effective management" is situated in India.[33] The term shall have the same meaning as currently laid down in the Tenth Schedule of the draft Code, that is:

a) the place where the Board of Directors (BoD) of the company or its executive directors, as the case may be, make their decisions; or
b) in a case where the BoD routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

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[32] Revised Discussion Paper on Direct Taxes Code, July 2010, Chapter XI, 35.

[33] *Id.,* Chapter VIII, 30.

Accordingly, applying situation a) as mentioned above, a company may be treated as a resident even when the BoD takes any routine or ordinary decision from India, and does not necessarily encompass situations where crucial strategic decisions are taken. Thus the contours are ambiguous and uncertain. In essence, though RDP attempted to address the concerns raised by DTC and DP on definition of "resident"[34], it failed to bring in clarity in this regard. Therefore, we suggest that the first condition should be clarified to state that the place of effective management is the place where *key management and commercial decisions that are necessary for the conduct of the entity's business are, in substance, made*. Else, the test of effective management shall not only broaden the ambit of taxability of companies, but also make the application of the test uncertain and be subject to interpretation by Courts at a subsequent stage, thereby making tax planning more difficult.

C. CONTROLLED FOREIGN CORPORATION PROVISIONS

RDP has proposed for Controlled Foreign Corporations (CFC) provisions in DTC. CFC is a corporate entity which conducts business in one jurisdiction (foreign company) but is owned or controlled primarily by the resident taxpayers of another jurisdiction. CFCs deliberately route their investments through tax havens to avoid payment of taxes on income at home. As income from a foreign source is taxed usually after it is accrued or received as income in the country of residence of the taxpayer, the mechanism enable the shareholders to defer the payment of taxes.[35]

Although RDP rightly tried to address the issue of deferment of payment of taxes, it tried to bring in the concept without elucidating upon its

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[34] Under § 4(3) of DTC, a company incorporated outside India (foreign company) whose affairs are "partly" or wholly controlled and managed from India, would be considered as a tax resident of India. Hitherto, a foreign company may be considered to be resident in India only if the "whole" of the control and management of its affairs are located in India. If, on the basis of control and management, a company is regarded as resident in India, its global income will be taxable in India. The proposed change could have far-reaching implications. For instance, several Indian companies have overseas subsidiaries. It is common to have nominee directors of the Indian companies on the board of the overseas subsidiaries. They may routinely participate in conference calls relating to overseas subsidiary while they are based in India. The business and risk management policies of the subsidiary may also be framed in the Indian headquarters. Such a subsidiary may qualify to be a "resident" under § 4(3) of DTC.

Whereas it may not be difficult to demonstrate that the "whole" control and management of affairs is not in India, the above situations could cast an enormous onus on the taxpayer to defend the absence of "part" control and management of affairs. Further, as DTC, as proposed by DP, does not define control and management of affairs, there may arise borderline cases which may lead to unwarranted litigation.

[35] K. R. Girish and Kanchan Dinakar, *Controlled Foreign Corporations — Is India ready for this tax regime?*, April 16, 2007, available at *http://www.thehindubusinessline.com/mentor/2007/04/16/stories/2007041601171300.htm (Last visited on June 14, 2010).*

different facets. According to RDP, passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes, shall be deemed to have been distributed. Consequently, it would be taxable in India in the hands of resident shareholders as dividend received from the foreign company.[36]

As evident from this proposal, RDP is silent on the extent of direct or indirect control by the Indian resident. For instance, it is unclear whether such control is meant to be in whole or in part. Further, it is unclear whether the passive income refers t o income earned by such CFC within or outside India. Moreover, RDP, while proposing the CFC provisions, completely overlooked legitimate business compulsions for not distributing the surplus in certain circumstances. For instance, it is silent on safe harbor rules for non-applicability of CFC provisions when the passive income is within a certain percentage of total income.[37]

D. DOUBLE TAXATION AVOIDANCE AGREEMENT

Double Taxation Avoidance Agreements (DTAAs) are commonly opted by multinational companies (MNCs) for enjoying tax benefits. It is a common practice among them to establish Special Purpose Vehicles (SPVs) in tax havens such as Mauritius or Cayman Islands for holding shares in downstream Indian companies.[38]

According to RDP, an assessee will be free to opt for either DTAA provisions or DTC, whichever is more beneficial.[39] Although RDP attempted to address the concerns raised by DTAA provisions in DTC[40], uncertainty still remains. DTAA, according to RDP, shall not *inter alia* enjoy preferential status when the Revenue Department invokes GAAR or CFC provisions. As the DTAA provision is evidently linked to the contours of GAAR and CFC provisions which remain highly ambiguous and unsatisfactory, RDP has not adequately addressed the concerns raised in this regard.

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[36] *Supra* note 33.

[37] ICAI, *ICAI Suggestions on the Revised Discussion Paper (RDP) on DTC*,July 8, 2010, available at http://www.forum4finance.com/2010/07/08/icai-suggestions-on-the-revised-discussion-paper-rdp-on-direct-taxes-code-dtc/ (Last visited on August 8, 2010).

[38] For instance, India has entered into a DTAA with Mauritius. According to the treaty, capital gains arising from the sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold. Therefore, a company resident in Mauritius, selling shares of an Indian company, is not liable to pay tax in India. Since capital gains tax is absent in Mauritius, the gains will not incur any tax liability at all.

[39] *Supra* note 32, Chapter IX, 31.

[40] DTC, as proposed by DP, attempted to override each of the 75 DTAAs that India had signed. The Code proposed that neither DTAA nor the Code shall have preferential status by reason of it being a treaty or law. § 258(8) of the Code adopted the 'later-in-time' doctrine, implying that the provisions of the new 2011 law could override every tax treaty that India had signed in the past.

V. CONCLUSION

Final and concrete conclusions cannot be drawn from *Vodafone* judgment as it was not dealing with the taxability of the transaction. The court was only considering the validity of the show-cause notice issued by the department. However, the final outcome in *Vodafone* case is expected to have potentially far-reaching implications. A successful tax claim can bring in any merger and acquisition activity conducted anywhere in the world under the tax net if the disposing entity has a subsidiary or permanent establishment in India. Though AAR ruling in *E*Trade* is forthcoming in use of corporate as a vehicle for tax planning, in legal terms, AAR is binding only on the applicant and the tax authority in respect of that case. It does not have general application. Further, as RDP is silent on whether GAAR can have retrospective effect vis-à-vis transactions undertaken prior to the enactment of DTC, any use of the corporate vehicle for tax planning can be perilous. Thus, we advise a cautious approach in using a corporate entity in tax planning especially considering the common practice among MNCs in establishing Special Purpose Vehicles (SPVs) in tax havens for holding shares in downstream Indian companies. It is advisable to obtain a nil withholding tax order from the tax authority before proceeding with any use of the corporation as a vehicle for tax planning.

GAAR, along the proposed lines, is likely to restrict the freedom of parties to enter into commercial transactions in a tax-efficient manner. The proposed framework is highly fragile and inadequate. If the provision is invoked in a casual manner, it would cause tremendous inconvenience and hardships for genuine and bona fide taxpayers and undermine the confidence, faith and trust of the taxpayer in the tax administration. Although proposals on GAAR in RDP will bring in a certain degree of certainty in tax management, they are inapposite as far as building inherent checks and balances are concerned. The proposals such as issue of guidelines and specifying threshold limit for tax avoidance enable the Department to unilaterally draw the contours of GAAR.

International experience has suggested taxpayer uncertainty as the most frequently cited argument against GAAR. In the light of this experience, Specific Anti-avoidance Rules (SAARs) must be given greater significance in DTC. Further, the burden of proof should be shifted to the revenue department and not the assessee. Several jurisdictions have enacted a separate appeal mechanism wherein the taxpayer, who is served a notice about the invocation of GAAR, may appeal against such decision within the specified time of such notification. This mechanism can act as a curb on the unbridled powers of Commissioner to invoke GAAR. However, such a mechanism is not provided in DTC. It is advisable to consider advance ruling mechanism akin to AAR.[41] Tax payers may approach AAR for obtaining pre-clearance in relation to the proposed

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[41] Puneeta Kundra, *Paradigm Shift in Tax Avoidance,* BUSINESS LINE, October 19, 2009, 8.

transactions. Although it can help in avoiding long drawn and expensive litigation, it may delay the fructification of commercial transactions. However, this may be a lesser evil compared to the uncertainty which may exist till the completion of due diligence. Further, Dispute Resolution Panel, as proposed in RDP, should include requisite number of businessmen and professionals to ensure balanced appreciation of an impugned transaction. Commissioners should also be trained and exposed to the prevailing practices in other jurisdictions such as Canada, Australia, South Africa and New Zealand. This will help them in understanding the nuances of the rule.[42] It will be naive to expect quality performance from them in the absence of adequate training programmes.

The applicability of DTAA is subject to GAAR and CFC provisions. As the contours of GAAR and CFC provisions are highly ambiguous, the applicability of DTAA has become unpredictable. Further, a company is a "resident" if BoD of the company or its executive directors take decisions in India. Accordingly, a company may be treated as a resident even when the BoD takes an ordinary decision in India. This can have far-reaching adverse tax implications. Thus the provision needs further staturoty elucidation to mean that the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are, *in substance*, made.

DTC condemns tax avoidance on moral, ideological and economic grounds.[43] However, payment of taxes may not be as sacrosanct as it is considered, which is well articulated in the observation of Sabyasachi Mukharji, J. in *Commissioner of Wealth Tax, Gujarat-II, Ahmedabad* v. *Arvind Narottam*[44]:

> *"*It is true that tax avoidance in an under-developed developing economy should not be encouraged on practical as well as ideological grounds. 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 ostentious consumption and deprivation for the large masses ask, is does he with taxes buy civilization or does he facilitate the wastes and ostentiousness of the few. Unless wastes and ostentiousness in Government's spendings are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance.*"*

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42 *Id.*

43 *Supra* note 26, Chapter XXIV, A-75.

44 Commissioner of Wealth Tax, Gujarat-II, Ahmedabad v. Arvind Narottam, AIR 1988 SC 1824.