After studying this chapter, you would be able to -

- **distinguish** between tax planning, tax avoidance and tax evasion.
- **analyse** whether a specified activity resulting in reduction of tax liability would be considered as tax planning, tax avoidance or tax evasion.
- **examine** the doctrine of form and substance in the context of tax planning.
- **advise** salaried individuals and HUFs to plan their investments/payments to minimise tax liability.
- **advise** corporates and businesses to plan their activities/structures in a tax-efficient manner.
14.1 TAX PLANNING, TAX EVASION AND TAX AVOIDANCE – AN OVERVIEW

Tax planning involves an intelligent application of the various provisions of the direct tax laws to practical situations in such a manner as to reduce the tax impact on the assessee to the minimum. A thorough understanding of the principles, practices and procedures of tax laws and the ability to apply such knowledge to various practical situations is expected at the final level.

(1) **Method of study of tax planning**: A thorough up-to-date knowledge of tax laws is a prerequisite for a successful study of tax planning techniques. Not only an up-to-date knowledge of the statute is necessary, but one must also be aware of the contents of the various circulars issued by the CBDT and also of case laws in the form of various decisions of the Courts. One of the best methods to study tax planning in action is to analyse the case laws. In view of this position, students should realise the importance and usefulness of keeping track of the judgments of Supreme Court and of various High Courts reported in tax law journals from time to time. Students should make it a point to go through the relevant cases and understand the issues involved and the rationale of the judgments. Of course, tax planning in a particular case would depend on the facts and circumstances of that particular case.

Apart from the above, students are advised to go through the articles on tax laws published in tax journals and financial papers. With this brief introduction, let us go into the basic concepts of tax planning.

(2) **Concept of tax planning**: Planning is the formulation of a system which in its implementation is designed to achieve a specific result. Economic planning is the privilege of the State; tax planning is that of the subject. Men, material and money are the resources available at the disposal of a nation and to conserve the same, the State resorts to economic planning. 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 utilised for the benefit of the individual or the business, as the case may be. Just as sound economic planning is indispensable for a welfare State, a sound tax planning is equally indispensable for the welfare of the citizen.

Before entering into a transaction or before starting a business, one normally considers its profitability and other aspects. Amongst other aspects, the tax implications of the transactions of the business have to be thought out before actually embarking on the deal. Otherwise one may be caught unwittingly in huge tax liability. Planning from the point of view of taxation helps in generating greater savings of investible surplus.

Tax planning may be defined as an arrangement of one’s financial affairs in such a way that, without violating in any way the legal provisions, full advantage is taken of all tax exemptions, deductions, concessions, rebates, allowances and other reliefs or benefits permitted under the Act so that the burden of taxation on the assessee is reduced to the minimum.

It involves arranging one’s financial affairs by intelligently anticipating the effects which the tax
TAX PLANNING, TAX EVASION AND TAX AVOIDANCE

laws will have on the arrangements now being adopted. As such it is a very stimulating intellectual exercise.

Any tax planning scheme should be a natural one and should not give an appearance of an artificial arrangement on the face of it. The tax planner or the tax adviser should exercise great care and caution in designing any tax planning scheme as its failure will result in great difficulties and heavy burden of tax on the assessee for whom the scheme is evolved.

(3) **Tax planning, tax evasion and tax avoidance**: Three methods of saving taxes have been developed in most countries of the world in the past few decades: tax evasion, tax avoidance and tax planning.

Reduction of taxes by legitimate means may take two forms — tax planning and tax avoidance. ‘Tax planning’ is wider in range. At this stage, the distinction between ‘tax avoidance’ and ‘tax evasion’ may be noted. The dividing line between tax evasion and tax avoidance is very thin. The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

“The distinction between ‘evasion’ and ‘avoidance’, therefore, is largely dependent on the difference in methods of escape resorted to. Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offered by the Government. Others are maneuvers involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. The first represents what is truly tax planning, the latter tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact, circumvent it with a view to eliminate or reduce tax burden. It is these methods which constitute “tax avoidance”.

Thus, tax evasion refers to any attempt to avoid payment of taxes by using illegal means. Some of the common forms of tax evasion are:

- misrepresentation or suppression of facts;
- failure to record investments in books of account;
- claim of expenditure not substantiated by any evidence;
- recording of any false entry in books of account;
- failure to record any receipt in books of account having a bearing on total income; and
- failure to report any international transaction or deemed international transaction or specified domestic transaction under Chapter X.

These constitute misreporting of income attracting penalty@200% under section 270A.

(4) **Judicial thinking—A brief study**: The judicial attitude towards tax avoidance schemes is very strict and the landmark judgment of the Supreme Court in *M/s. Mc Dowell and Co. Ltd. vs.*
Commercial Tax Officer 1985 Taxman 77(3) (1985) 154 I.T.R. 148 (SC) is proof of the same. Though this decision was rendered in the context of A.P. General Sales Tax Act, the principles emerging out of this decision will have relevance to direct taxes also.

Before discussing the relevant observations of the Supreme Court in relation to tax avoidance scheme it will be instructive to have an idea of the development in judicial thinking in England since our own judicial thinking on the subject has been largely derived from English thinking.

**English Scene:** In Inland Revenue Commissioner vs. Duke of Westminster 1936 AC 1 it was held “Every man is entitled if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”

After the World War II and the consequent huge profiteering and racketeering the attitude of the courts towards the avoidance of tax perceptibly changed and hardened. Commenting on a tax avoidance scheme, the court observed that it scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.

It was felt that there must be some limit to the devices which courts can put up with in order to defeat the fiscal intentions of the legislature. A very significant departure from the Westminster Principle was made in Ramsay vs. Inland Revenue Commissioners (1982) AC 300. It was felt in that case that even though the doctrine that courts could not go behind a given genuine document or transaction to some supposed underlying substance was a cardinal principle, it must not be overstated or over-extended. While obliging the courts to accept documents or transactions, found to be genuine, as such, the doctrine did not compel the court to look at the document or transaction in blinkers isolated from any context to which it properly belonged. If it could be seen that a document or transaction was intended to have effect as a part of a nexus or series of transactions or as an ingredient of a wider transaction intended as a whole, there was nothing in the doctrine to prevent it being so regarded. To do so was not to prefer form to substance or substance to form. It was the task of the court to ascertain the legal nature of any transaction to which it was sought to attach a tax consequence and if that emerged from a series or combination of transactions, intended, apart as such, as was that series or combination which might be regarded.

Thus, two points were established. The first was a significant change in the approach adopted by the court with regard to its judicial role towards tax avoidance scheme. The second was that it was crucial when considering any such scheme to take the analysis far enough to determine where the profit, gain or loss was really to be found. It was also stated that the fact that the court accepted that each step in a transaction was a genuine step producing its intended legal results did not confine the court to consider each step in isolation for the purpose of assessing the fiscal results. Thus, we can say that the true principle of the decision in Ramsey was that the fiscal consequence 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 and not by dissecting the scheme.
and considering each transaction separately.

In *I.R.C. vs. Burmah Shell Co. Ltd.* (1982) STC 30 (Burmah) and *Furniss (Inspector of Taxes) vs. Dawson* (1984) 1 All E.R.530, it was held that where tax avoidance was targeted through a series of transactions with no commercial or substantial value but with the only aim of avoiding tax, the Courts have to ignore the transactions and the tax liability has to be determined as if these transactions never took place.

**Indian Scenario:** In *CIT vs. A. Raman & Co.* 1 SCR 10, the Supreme Court followed the dictum of the Westminster’s case. It observed that avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. The tax payer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon consideration of morality but on the operation of the Income-tax Act, 1961. Legislative injunction in taxing statutes may not, except on pain of penalty, be violated but it may lawfully be circumvented. The same view was expressed in *CIT vs. Kharwar* 72 ITR 603 as follows:

“The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction, if the parties have chosen to conceal by a device the legal relation, it is open for the taxing authorities to unravel the device and to determine the true character of relationship. The legal effect of a transaction, however, cannot be displaced by probing into the substance of the transaction.”

However, the Supreme Court in *Mc Dowell’s* case clearly departed from the above views and expressly disassociated itself with the earlier observations of the Supreme Court echoing the sentiments of Westminster principle. The court enumerated the evil consequences of tax avoidance as follows:

1. Substantial loss of much needed public revenue.
2. Serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation.
3. Large hidden loss to the community by some of the best brains of the country involved in perpetual litigation.
4. Sense of injustice and inequality which tax avoidance arouses in the minds of those who are unwilling or unable to profit by it.
5. The unethical practice of transferring the burden of tax liability to the shoulders of the guileless, good citizens from those of the ‘artful dodgers’.

The court felt that there was as much moral sanction behind taxation laws as behind any other welfare legislation and avoidance of taxation was not ethical.

In the view of the Court, the proper way to construe a taxing statute while considering a device to avoid tax was not to ask whether the provisions should be construed literally or liberally, nor
whether the transaction was not unreal and not prohibited by the statute, but whether the transaction was as device to avoid tax and whether the transaction was such that the judicial process might record its approval to it.

The court felt that it was neither fair nor desirable to expect the legislature to intervene and take care of every device to avoid taxation. It was up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation as was done in Ramsey’s case to expose the devices for what they are really worth and to refuse to give judicial benediction.

The Supreme Court emphasised that tax planning may be legitimate provided it is within the framework of law and colourable devices cannot be part of tax planning. It is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. The Supreme Court also recommended that it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuge.

It is significant to note that in deciding *Mc Dowell’s case*, the Supreme Court was not content in merely adjudicating the dispute as to whether sales tax was leviable on the Central Excise paid by the purchaser on behalf of the seller and not exhibited in the bill. It also stated in this case that it decided to break away from the long tradition of earlier cases holding that tax avoidance is both legitimate and legal.

Another significant case decided by the Supreme Court, though involving a dispute relating to payment of bonus, is worthy of reference at this stage as it also reflects the same thinking as in *Mc Dowell’s case*. In *Associated Rubber Industries case* (1986) 157 ITR 77, a new wholly owned subsidiary company was created with no asset of its own except investments transferred by the holding company with no business income, except receiving dividend from the transferred investments. The Supreme Court held that on facts, the purpose of such a transfer of investments was nothing but to reduce the gross profits of the holding company and thereby to reduce the payment of bonus. There was no direct evidence that the subsidiary was formed as a device to reduce the gross profits of the principal company for whatever purpose. But Justice Chinnappa Reddy in passing his judgment was following the principles earlier laid down by him in *Mc Dowell’s case* and was of the opinion that the transfer of shares was nothing but a device like tax evasion to avoid a welfare legislation like the Payment of Bonus Act. It was observed that it is the duty of the Court in every case where ingenuity is expended to avoid liability to taxation and welfare legislation, to get behind the smoke screen and discover the true state of affairs.

The above decision seems to have introduced a new doctrine that it is upto the court to take stock, weigh out sophisticated legal devices and expose the devices for what they really are. The fact that this new doctrine has started gaining ground very fast is seen from a quick succession of decisions, after *Mc Dowell in Kartikeya vs. Sarabhai* and in *Associated Rubber’s case*. The above change in the trend of judicial thinking clearly shows that the line of demarcation between Tax Planning and Tax avoidance.
In order to curb tax avoidance, provisions such as applicability of transfer pricing provisions in respect of specified domestic transactions, treating any transaction with the person located in the notified jurisdiction areas to be treated as international transaction, General Anti-avoidance Rules, provisions relating to furnishing of Tax Residency Certificate for claiming benefit of double tax avoidance agreements have been introduced.

The decision in *Mc Dowell’s* case and the subsequent developments have evoked lot of debate in all legal and tax circles.

The Gujarat High Court in *CIT vs. Smt. Minal Rameshchandra (1987) 61 CTR (Guj) 80* had occasion to consider the impact of *Mc Dowell’s* case. The following propositions appear to emerge from the same.

1. *Mc Dowell’s* case and observations therein cannot be ignored and these are binding on all courts.
2. *Mc Dowell’s* case and observation therein should be understood in the context of questioning the legitimacy of use of artificial and transparent device and sham practices to circumvent the law.
3. Where the arrangement cannot be dismissed as an artificial tax device (and not as a legitimate transaction), the subject can be taxed only having “regard to strict letter of the law and not merely to the spirit of the statute or the substance of the law” and had been consistently laid down earlier. In this sense there is no radical departure from law, prior to *Mc Dowell* case.

In *C.W.T. vs. Arvind Narottam 173 ITR 479 (SC)* judge Sabyasachi Mukerji made the following significant observations:

1. Where the language of the deed of settlement is plain and admits of no ambiguity there is no scope for considerations of tax avoidance.
2. One would wish as noted by Chinnappa Reddy in *Mc Dowell’s* case that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary tax payers very often in a country of shortages (with ostentatious consumption and deprivation for the large masses) ask is does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in government spending are avoided or eschewed no amount of moral sermons would change people’s attitude to tax avoidance.
3. Where the true effect on the construction of the deeds is clear, appeal to discourage tax avoidance is not a relevant consideration”.

In the light of the above development we have to ascribe a proper meaning to the concept of tax-planning. We can take a cue from the structure of our tax laws.
Our tax laws tend to serve a dual purpose of collecting revenue and of achieving certain social objectives. There are in-built tax incentives which promote savings and investments in new enterprises and facilitate development of backward areas. A lot of exemptions and incentives are provided in all the direct taxes. If an assessee takes maximum advantage of these incentives, exemptions etc. and enlarges the scope of his disposable resources, there can be no objection because the legislature wants the optimum utilisation of these incentives to promote economic activity in the country. The complexity of our tax-laws makes it impossible for even an intelligent assessee to comprehend them properly and avail all the reliefs which may be genuinely provided by such laws. Moreover, the interaction of other laws such as MRTP Act, FERA, Companies Act etc. make the exercise much more complicated. It requires, therefore, meticulous planning to bring down the tax commitments keeping in view not only the statutes but also the judge-made law. We may say that the above area properly belongs to tax-planning. In this sense there is nothing unethical about tax-planning.

Due to constant changes in the law and new court decisions, it is always necessary to have a continuous review in relation to all matters of tax planning so that appropriate changes are introduced without delay.

It may be noted that the scope of the three English cases of Ramsay, Burmah Oil Company and Dawson have been substantially narrowed by a more balanced view on tax planning in the case of ‘Craven vs. White’

(5) **Doctrine of form and substance**: One of the reasons which prompts a tax payer to resort to tax planning is the existence of the doctrine of form and substance. The principle involved in this doctrine is simple. How far Court may stretch the wording of a Statute to cover a particular set of facts, where those facts have clearly been created by a tax payer in order to avoid or minimise his tax and the literal interpretation of the Statute is not, at first sight apt to cover them? Is it possible to ignore the form of a transaction and determine the substance thereof?

In *Commissioner of Income tax vs. Motor and General Stores (P) Ltd. (1967) 66 ITR 692 (SC.)* the Supreme Court had observed that in the absence of any suggestion of bad faith or fraud the true principle is that the taxing statute has to be applied in accordance with the legal rights of the parties to the transaction. According to the court, when the transaction is embodied in a document the liability to tax depends upon the meaning and content of the language used in accordance with the ordinary rules of construction. The House of Lords in *Duke of Westminster vs. ICR (1936) 19 ATC 498* held that in considering the substance of the transaction, the legal form cannot be disregarded.

It was held in *CIT vs. B.M. Kharwar (1969) 72 ITR 603 (SC)* that the taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by device the legal relation, it is open to the taxing authority to unravel the device and to determine the true character of the relationship. However, the legal effect of a transaction cannot be displaced by probing into ‘the substance of the transaction’. This principle
applies alike to cases in which the legal relation is recorded in a formal document and to cases where it has to be gathered from the evidence - oral and documentary - and the conduct of the parties to the transaction. However, this view of the Supreme Court has now been expressly disapproved by the Supreme Court in *Mc Dowell & Co. Ltd’s case*.

Justice Shah, in *Ram Laxman Sugar Mills vs. CIT (1967) 66 ITR 613, 617 (SC)*, has stated that to ascertain the legal effect of a transaction, the court seeks, in the first instance, to determine the intention of the parties and if ambiguous expressions are used, the court may normally adopt such interpretation consistent with the parties thereto having acted on the assumption of its validity. Thus, any claim made by a tax-payer will be scrutinized from the point of view of his intention and if there was any intention to defraud the revenue, the court will consider the transaction or the claim as fraud.

Thus, we can say that unless there is clear evidence of *malafide* intention resulting in a form which is a “colourable device” or “mere legal facade” or “non-genuine” form the tax authorities are not justified in disregarding the legal form and probing into the substance of the transaction.

**Principles governing the form and substance:** Theory of interpretation of a taxing statute:

(i) It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into in another form which is equally lawful, it may not. In considering, therefore, whether a transaction attracts tax or not, the form of the transaction put through by the assessee is to be considered and not the substance thereof.

(ii) The above rule cannot naturally apply where the transaction, as put through by the assessee, is not genuine but colourable or is a mere device. For here, the question is not one between ‘form’ and ‘substance’ but between appearance and truth.

(iii) In deciding whether the transaction is a genuine or colourable one, it will be open to the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction.

(iv) Where the authorities are charged under the Act with the duty of determining the nature or purpose of and payment or receipt on the facts of a case, it is open to them to work at the substance of the matter and the formal aspect may be ignored.

(v) Where the terms of a transaction are embodied in a document, it should not be construed only in its formal or technical aspect. While the words used should be looked at, too much importance should not be attached to the name or label given by the parties and the document should be interpreted so as to accord with the real intention of the parties as appearing from the instrument.

As noted earlier, the decisions of the Supreme Court in the cases of *Mc Dowell, Karthikeya Sarabhai and Associated Rubber Industries*, clearly show a preference for the ‘substance’ over the
‘form’, if the circumstances of the case warrant such a preference. Where the transactions are genuine, perfectly authentic and not sham, the mere fact that the transaction results in less liability or no liability to tax should not put the transaction to a legal scrutiny questioning the substance of the transaction, attributing a motive behind it. It is up to the Court to take stock of the situation, weigh out sophisticated legal devices and expose the devices for what they really are.

(6) **Successful tax planning — tests to be satisfied:** Tax planning in any case will entirely depend on the individual facts and circumstances. It is a tool in the hands of the taxpayer and tax practitioners for selective use. It is essential to comprehend (a) that the facts bearing on the issue are evidenced by proof; (b) that the associated legal consequences, both under the personal and under the tax laws, are fully borne in mind; and (c) that the situation warrants implementation of “tax planning”. Successful tax planning must conform to two outstanding tests viz, (a) conformity with the current law and (b) flexibility.

In order to satisfy the first test, the essential requisite is a comprehensive knowledge of the law, rules and regulations on the part of the tax planner. This knowledge of law extends not only to the provisions of the taxing statutes and the case law that has developed on those statutes, but also to other branches of law, both civil and personal, so that the tax planner’s device does not get defeated by the universal principles of jurisprudence.

The second test of flexibility seeks to ensure that the success of the tax planning device is not nullified by statutory negation. Though the tax planner may be successful in seeking out a device which in his opinion is in conformity with law, the subsequent statutory negation may nullify his success. In order to counter this exigency, his tax plan must be flexible. Flexibility essentially means that the device provides for suitable changes in accepted forms. Flexibility is a practical concept. Its introduction and utilisation depend upon the circumstances of the case. Under certain circumstances flexibility may be of no avail. As a matter of fact, flexibility may invalidate the tax plan. But when flexibility is permissible the tax planner will do well to remember to keep this test in mind to counter the measures of statutory negation. In view of this position wherever possible, tax planning schemes should be flexible, designed so as to avoid irretrievable situations. The tax planner should therefore be watchful of all significant developments related to his field.

In order to be a successful venture, efforts at tax planning should not ignore the legislative intent; they should be directed in every case to see that not only the tax benefits are obtained but also the tax obligations are discharged without fail so that the penal provisions are not attracted.

(7) **Retrospective Legislation:** Every tax planner will inevitably have to face the question of retrospective legislation and the specific problems arising from the retrospective application of tax rates and tax amendments. Tax planning often flounders on the rock of retrospective legislation. The cardinal principle of construction is that a statute must always be interpreted prospectively unless the language of the statute makes it retrospective either expressly or by necessary implication. A retrospective operation is not to be given to a statute so as to impair vested rights or the legality of past transactions.
Unless the terms of statute expressly so provide or unless there is a necessary implication, retrospective operation should not be given to the statute so as to affect, alter or destroy any right already acquired or to revive any remedy already lost by efflux of time. If the law is amended so as to make it applicable retrospectively to any assessment year, the question at issue in respect of the assessment year will have to be decided in the light of the law so amended and it shall be so even if the matter is at the appellate, revisional or reference stage.

The history of tax laws of our country is replete with instances of retrospective amendment of law. It is obviously competent for the Legislature, in its wisdom, to make the provisions of an Act of Parliament retrospective and no one denies the competency of the Legislature to pass retrospective statutes if they think fit and many time they have done so, but, before giving such a construction to an Act of Parliament one would require that it should either appear very clearly in the terms of the Act or arise by necessary and distinct interpretation. A retrospective operation is not to be given to a statute as to impair existing right or obligation otherwise than as regards matters of procedure unless that effect cannot be avoided without doing violence to the language of the enactment. If the enactment is expressed in language which is fairly capable of either interpretation, it ought to be construed as prospective only.

In our country, the Government generally follows the principle that the changes in the rates of tax, as also the other amended provisions of tax laws, should ordinarily be made operative prospectively in relation to current incomes and not in relation to incomes of the past year. However, there are cases where the Government have thought it fit to introduce retrospective amendments in tax laws. The Supreme Court has upheld the validity of such retrospective laws. Any retrospective legislation has two aspects. For pending assessments, the amended provision would be applied. The difficulty would arise in the case of completed assessments. The effect of a retrospective legislative amendment is that the provisions as amended, shall, for all legal purposes be deemed to have been included in the statute from the date on which the amendment came into force. All orders relating to periods subsequent to the date of retrospective amendment must be in consonance with the specific and clear provisions, as amended retrospectively. Therefore, the case will be construed as if there is mistake apparent from the record which can be rectified under section 154 [M.K. Venkatachalam vs. Bombay Dyeing and Manufacturing Co. Ltd. (1958) 34 I.T.R. 134 (S.C.)]. Conversely, by virtue of a retrospective amendment, an order which was inconsistent with the clear terms of a provision at the time when the order was made, may become one in consonance with that provision and thereafter, there remains no scope for passing a rectification order [SAL. Narayana Rao vs. Ishwarlal Bhawan Das (1965) 57 L T.R. 149 (S.C.)].

For instance, the Finance Act, 2012 had introduced amendments to certain provisions of income-tax law, which were stated to be clarificatory and, accordingly, introduced with retrospective effect from the date of insertion of the respective provisions. Subsequently, considering the severity of the consequences of such retroactive amendments, the CBDT issued a clarification directing the tax authorities not to reopen completed tax assessments on account of the clarificatory
amendments made by the Finance Act, 2012. However, the clarification does not extend to assessment orders which are pending adjudication before a judicial authority or if reassessment proceedings have already been initiated before 1st April 2012.

8. Systems and methods of tax planning: The systems and methods of tax-planning in any case will depend upon the result sought to be achieved. Broadly, the various methods of tax-planning will either be short-range tax-planning or long-range tax-planning.

The short-range tax planning has limited objective. An assessee whose income is likely to register unusual growth in a particular year on account of say, sale of capital asset like house property, as compared to the preceding year might plan to invest the same in notified bonds, bonds of National Highway Authority of India or Rural Electrification Corporation Limited to claim exemption under section 54EC. This has a lock-in period of 3 years. Such a plan does not involve any permanent or long-term commitment and yet it results in substantial tax saving. This is an example of short-range tax planning.

The long-range tax planning, on the other hand, may not even confer immediate tax benefits. However, it may pay-off in none too distant a future. For instance, in a case where an assessee transfers certain shares to his spouse, the income arising from the shares will, of course, be clubbed with the transferor’s income. However, if the company subsequently issues bonus shares in respect of those shares the income arising from the bonus shares will not be clubbed with the transferor’s income. Similarly, the income arising out of the investment of the income from the transferred assets will not also be clubbed with the transferor’s income. Long range tax planning may be resorted to even for domestic or family reasons.

In relation to income-tax, the following may be noted as illustrative instances of tax-planning measures:

(a) Varying the residential status taking into consideration the number of days of stay in India to be a resident, in case of an individual.
(b) Choosing the suitable form of assessable entity (individual, HUF, Firm, Co-operative society, Association of persons, Company, Trust, etc. to obtain optimal tax concessions)
(c) Choosing suitable forms of investment (share capital, loan capital, lease, mortgages, tax exempt investments, priority sector, etc.), considering deductions available in respect of interest, exemption available in respect of dividend etc.
(d) Programmed replacement of assets to take free advantage of the provisions governing depreciation.
(e) Diversification of the business activities (hotel industry, agro-based industry etc.) considering the various profit-linked and investment-linked benefits available under the provisions of the Act.
(f) The use of the concept of commercial expediency to claim deduction in respect of expenditure, in computing business income.

(9) **Tax planning in the context of administrative legislation**: It is a common feature of modern legislative enactment to lay down in the section of the Act, the principles and the policy of the Legislature leaving out details to be filled in or worked out by rules or regulations made either by the Government or by some other authority as may be empowered in the legislation. This kind of subordinate or administrative legislation is justified and even necessitated by the fact that the Legislature has neither the time nor the material to consider and enact rules relating to various details as they may not be acquainted fully with the facts and circumstances relating to the subject matter and may have no time to consider such details. Section 295(1) of the Income-tax Act, 1961 vests with the CBDT, the power to make rules for carrying out the requirements of these Acts. This power also enables the Board to give retrospective effect to any of the rules in such a way as not to prejudicially affect the interests of any taxpayer.

The various matters in respect of which the rules may be framed are specified in the relevant sections. Rules are made by the appropriate authority in exercise of the powers conferred on it under the provisions of the Act. Therefore, they have statutory force and fall within the scope of the law made by the Legislature itself. Thus, they are a part of the enactment which imposes the tax. *Since the Rules are meant only for the purpose of carrying out the provisions of the Act, they cannot take away what is conferred by the Act nor whittle down its effect. Therefore, rules can only be made in consonance with the provisions of the Act. They must be interpreted in the light of the section under which they are made. If there is an irreconcilable conflict between a rule and a provision in the Act, the provision in the Act is to prevail and the rule which is subordinate to the Act must give way.*

Similarly, notifications are also issued in exercise of a valid authority bestowed under the statutes. Such notifications, when validly made in exercise of the authority provided for in the law, are binding on all concerned and may be enforced.

The following principles emerging from various rulings are relevant in this context.

1. The rule making authority cannot frame a rule which is contrary to the object and provisions of the Act from which its rule making power is derived.

2. A rule cannot over-reach the subject-matter relevant to the particular provision in the Act.

3. A rule cannot whittle down, negate or take away (directly or by implication or causation) the right, privilege, advantage or benefit granted by the section or the enactment relevant to it.

4. A rule cannot create any disability, limitation or other condition not sanctioned by the Act to which it is relevant or not consistent with the Act.
5. A subordinate authority cannot seek to sit in judgement over the rights of the subject nor decide questions of law and fact or otherwise usurp the functions of a Court.

6. No rule can be framed nor regulation promulgated contrary to the rules of natural justice.

7. A rule cannot seek to impose a tax which the Legislature has not thought it fit or expedient to impose.

8. A rule has to strictly confine itself to the subject-matter for which the rule-making authority has been empowered by the enactment.

9. In providing for a rule-making power, however wide the terms of that power be, as long as the Legislature has laid down the necessary guidelines for exercise of such rule-making power of the subordinate authority and as long as the Legislature has clearly laid down in the enactment the legislative object and policy and has retained in itself the ultimate legislative power, the enactment delegating power to a subordinate authority cannot be said to be ultra vires the Legislature or the enactment.

10. Both a rule and a provision of law are equally bound to respect the constitutional protection and fundamental right of the citizen enshrined in Article 14 of the Constitution.

11. Merely because a rule is subsequently laid before the Parliament, it cannot be given the status of a law of Parliament.

12. As in the case of an enactment, if a rule classifies persons and objects into identifiable classes and such classification is relevant to the purpose of the enactment and for carrying out the provisions of the Act, it cannot be called in question.

13. A rule has no retrospective operation unless the Act to which it is relevant specifically provides for the making of rules having retrospective operation.

14. The power to notify or to exempt also carries with it necessarily the power to denotify, rescind or withdraw the notification or exemption.

The above principles may be kept in mind while deciding about embarking on tax-planning.

Section 119(1) enacts that all officers and other persons employed in the execution of that Act shall observe and follow the orders and instruction or direction of the Board, provided that no such orders, instructions or directions shall be given so as to interfere with the discretion of the Commissioner (Appeals) in the exercise of his appellate functions. It is judicially settled that the Circulars issued by the Board would be binding under Section 119 on all the officers and persons employed in the execution of the Act [Navnilal vs. Sen (1965) 56 I.T.R. (198 SC)]. Consequently, if the Assessing Officer contravenes any circular issued by the Board in respect of, say, non-eligibility to tax of a certain item of receipt, he can be called upon by the appellate authority [the Commissioner (Appeals) or the Appellate Tribunal] to obey such a circular. The circular is not such a law that it should be taken judicial notice of; but after the circular has been brought to the notice of appellate authority, it would be competent to the appellate authority to direct the Assessing...
Office to correct his mistakes in his not giving effect to the circular. However, it may be noted that opinions expressed by the CBDT in its individual communication to the assessee on issues affecting (for example, as to when the new industrial undertaking established by the assessee began to manufacture or produce articles within the meaning of section 80-IA) cannot be considered as directions binding on the Income-tax authorities under section 119. The CBDT is not competent to give directions regarding the exercise of any judicial power by its subordinate authorities [J.K. Synthetics Ltd. and other vs. Central Board of Direct Taxes (1972) 83 ITR 335 (SC)].

The various judicial rulings which have considered the legal aspects of Circulars under the Income-tax Act, 1961 point out the following:

(i) The instructions of the Board are binding on the Department but not on the assessee.

(ii) The instructions in favour of the assessee should be followed by the Department, irrespective of the question of their legality; but the instructions adverse to the assessee can be challenged by the assessee.

(iii) Instructions adverse to the assessee cannot be issued with retrospective effect, while instructions favourable to the assessee can be so issued.

(iv) Instruction withdrawn subsequently should be given effect to by the Assessing Officer for the assessment year for which they were in force even though they are withdrawn at the time he makes the assessment.

(v) In the exercise of its power, the Board cannot impose a burden or put the assessee in a worse position but the Board can grant relief or relax the rigour of the law.

(vi) No instruction or circular can go against the provisions of the Act. While the Board can relax the rigours of the law or grant relief which is not to be found in the terms of the statute, it cannot issue any instruction which will be ultra vires of the provisions of the statute.

(vii) Circulars and instructions of the Board are envisaged only in regard to administrative aspects and cannot restrict the judicial power or the discretion of an officer -ALA Firm vs. CIT 102 ITR 622 (Madras), Sirpur Paper Mills Ltd. vs. CWT 77 ITR 6 (SC).

(viii) No such orders, instructions or directions shall be issued — (a) so as to require any income-tax authority to make a particular assessment or to dispose of a particular case in a particular manner or (b) so as to interfere with the discretion of the Deputy Commissioner (Appeals) or the Commissioner (Appeals) in the exercise of his appellate functions.

In making an assessment or levying a penalty, the Assessing Officer exercises a quasi-judicial power conferred on him by the Statute and has to act independently. He cannot act on advice of a stranger even though that person may be an authority superior to him in official hierarchy — Sheo Shankar Sitaram 95 ITR 523 (All).
(ix) Administrative instructions cannot also override the statutory rules.

In view of this position, the tax planner, while planning his affairs or that of his clients must take into account not only the relevant legal provisions which affect him but also all relevant rules, notifications, circulars, etc. As for circulars, since they are in the nature of administrative or executive instructions, the possibility that they might be withdrawn by the Board at any time, should also be taken into account. They may be challenged in the Courts although, otherwise they are binding at the administrative level (i.e., below the High Court or the Tribunal). In case where the circulars are based on erroneous and untenable footings, they are also liable to be quashed by the Court/Government.

(10) **System of advance rulings:** A ruling is a statement in writing to a taxpayer from the prescribed tax administering authority which interprets and applies the law and regulation to a specific set of facts and states a conclusion as to the tax consequences of that particular transaction. As the rulings are given in advance of the concerned transactions they are called advance rulings. The advance rulings given are binding on the tax authorities and the applicant who had sought such ruling, with reference to the particular cases in respect of which they are given. A change in the facts can affect the basis of the rulings because the law often pivots on a date, an amount, type of tax payer and so on. Likewise, a ruling issued with respect to one transaction may not be good to the same tax payer for a subsequent transaction even on what might appear to be identical facts.

Advance rulings are an excellent device for fostering and encouraging the self-assessment system and would contribute to good relations between the administration and tax paying public. From the tax payer’s point of view, these rulings are most desirable because they give more assurance of certainty prior to entering into a transaction and guarantee more uniformity in the application of the tax legislation. They are desirable for the administration also as they minimise the scope for controversy and litigation, reduce the time spent in answering question from tax payers and help to achieve a fair and co-ordinated tax administration.

Advance Ruling means written opinion or authoritative decision by an Authority empowered to render it with regard to the tax consequences of a transaction or proposed transaction or an assessment in regard thereto. The term has been defined in section 245N(a) of the Income-tax Act, 1961.

Chapter XIX-B of the Income-tax Act, 1961, provides for a scheme of advance rulings. For detailed reading, students may refer to Chapter 4 of Part II: International Taxation.

(11) **Construction and Interpretation:** No tax can be imposed on the subject without words in the Act clearly showing an intention to lay a burden upon him. In other words, the subject cannot be taxed unless he comes within the letter of the law.

(a) **Natural Justice:** This, however, does not mean that there is no scope for natural justice. Tax laws have to be interpreted reasonably and in consonance with justice. Where a literal construction would defeat the obvious intention of the legislation and produce a wholly...
unseasonable result, the court must achieve that obvious intention and produce a rational construction. If the interpretation of a fiscal enactment is open to doubts, the construction most beneficial to the subject should be adopted, even if it results in his obtaining “a double advantage”. A provision for exemption of relief should be construed liberally and in favour of the assessee. Likewise, a provision for appeal should be liberally construed. In cases of doubt regarding the construction, assistance may be sought from previous judicial interpretation or from previous legislation or by adverting to the mischief intended to be suppressed. A subsequent enactment affords no useful guide to the interpretation of earlier law, unless it is on the same subject and the earlier law is ambiguous.

Generally speaking, the sections in the Act do not overlap one another and each section completely covers the matter with which it deals. As far as possible the Act should be construed in such a way as to reconcile the various provisions and unravel apparent conflict into harmony bearing in mind that a general provision cannot derogate from a special provision regarding a certain class of cases. If a case appears to be governed by either of two provisions, it is clearly the right of the assessee to claim that he should be assessed under that one which leaves him with a lighter burden.

Those sections which impose the change of levy should be strictly construed but those which deal merely with the machinery of assessment and collection should not be subjected to a rigorous construction but should be construed in a way that makes the machinery workable.

The draft of a Bill which is afterwards enacted in the form of a statute and the report of a Commission or Select Committee appointed to deal with the subject are not admissible as aids in construing the provisions of the Act but the statement of objects and reasons may be referred to for the limited purpose of ascertaining the conditions prevailing at the time and the extent and urgency of the defect sought to be remedied.

(b) Definition clause and undefined words: A definition or interpretation clause which extends the meaning of a word should not be construed as taking away its ordinary meaning. Further, such a clause should be so interpreted as not to destroy the basic concept or essential meaning of the expression defined, unless there are competing words to the contrary. Words used in the sections of the Act are presumed to have been used correctly and exactly as defined in the Act and it is for those who assert the contrary to show that there is something repugnant in the subject or context. Words which are not specifically defined must be taken in their legal sense or their dictionary meaning or their popular or commercial sense as distinct from their scientific or technical meaning unless a contrary intention appears.

(c) Legal fiction: The word “deemed” may include the obvious, the uncertain and the impossible. A legal fiction has to be carried to its logical conclusion but only within the field of definite purpose for which the fiction is created. As far as possible, a legal fiction should not be so interpreted as to work injustice.
(d) **Marginal Notes:** Marginal notes to the sections cannot control the construction of the statute but they may throw light on the intention of the legislature.

(e) **Provisos:** A proviso cannot be held to control the substantial enactment or to withdraw by mere implication any part of what the main provision has given. A proviso is not applicable unless the substantive clause is applicable to the facts of the case. The proper function of a proviso is to provide an exception to a case which would otherwise fall within the general language of the main enactment and its effect as confined to that case. However, a proviso may be read as an independent substantive enactment where the context warrants such construction. Whether a proviso is construed as restricting the main provision or as a substantive clause, it cannot be divorced from the provision to which it stands as a proviso. It must be construed harmoniously with the main enactment.

12 **Doctrine of Precedence:** Doctrine of Precedence would be applicable in case of tax laws. The following principles which govern the rule of precedence may be noted.

- **Supreme Court:**
  (i) The Supreme Court judgments are absolutely binding on all the courts, Tribunals and authorities.
  (ii) Not only the *ratio decidendi*, but also *obiter dicta* of the Supreme Court are binding on all the Courts.
  (iii) When there are two irreconcilable decisions of the Supreme Court on some point of law, the decision of a larger Bench shall prevail.
  (iv) When there are two irreconcilable decisions of two Benches of similar strength, the decision later in time will have to be followed by the lower courts.
  (v) The Supreme Court judgments cannot be ignored by the lower courts though such judgments are *per incuriam*.
  (vi) The Supreme Court, though expected to follow its own judgments, is not bound to follow them and in appropriate cases it can review its earlier judgment.

- **High Courts:**
  (i) A Division Bench of a High Court is generally bound by its earlier decision, but it may refuse to follow the same if the earlier judgment is *per incuriam*.
  (ii) If the Division Bench of a High Court does not agree with its earlier judgment it will have to either follow the same or refer the issue to a Full Bench.
  (iii) A Division Bench of High Court is bound to follow a decision of the Full Bench of the same High Court.
  (iv) A single judge of a High Court is bound by a decision of a Division Bench or of the Full Bench of the same High Court.
(v) A single judge of a High Court is not bound to follow the decision of another single judge, though he is expected to follow the same.

(vi) All the lower authorities, courts and tribunals are absolutely bound to follow the decision of a High Court within whose jurisdiction they function. Here, the High Court decisions include decision of a single judge.

(vii) The lower authorities and courts can ignore a decision of a High Court only if it is overruled by a larger Bench of the same High Court, or by the Supreme Court or by a later enactment.

♦ Others:

(i) The Assessing Officer and the Commissioner, while acting under section 263, cannot refuse to follow the decision of High Court. They cannot pass orders which are inconsistent with the decisions of the High Court within whose jurisdiction they function, even for the purpose of keeping the issue alive.

(ii) In all Indian Acts like the Income-tax Act, 1961, to keep the uniformity of law, a High Court should normally follow the decision of another High Court, unless it finds an overriding reason not to follow the same.

(iii) The lower appellate authorities are bound to follow the decision of another High Court, though they do not function within the jurisdiction of the said High Court, if there is no contrary decision of any other High Court.

(iv) The Assessing Officer or the Commissioner need not follow the decision of another High Court if the department has not accepted the said decision and has taken the matter to Supreme Court.

(v) The Bench of the Appellate Tribunal, should generally follow the orders of other Benches of the Tribunal, unless those orders of the Tribunal are per incuriam.

(vi) An order of a Full Bench of a Tribunal is binding on the ordinary Bench of the Tribunal.

(vii) If an ordinary bench of a Tribunal does not agree with an order of another Bench of the Tribunal, and that order of the other Bench of the Tribunal is not per incuriam, the Bench cannot differ from the view taken by the other Bench. It can only get the matter referred to a larger Bench. But this is subject to the general rule that as far as possible, the Bench should try to follow the orders of the Benches.

(viii) The Tribunal orders are binding on the Commissioner (Appeals) falling within the territorial jurisdiction of the Tribunal passing the order in question.
(ix) The Assessing Officer and the Commissioner are bound by the order of the Tribunal (falling within the jurisdiction of the Tribunal unless the Department has not accepted the decision of the Tribunal.)

13) **Diversion of income by overriding title and application of income**: The concept of ‘diversion of income by overriding title’ signifies diversion of income at source by an overriding title before it reaches an assessee. Such a diversion can take place either under a legal compulsion or under a contractual obligation or otherwise. An obligation to apply the income in a particular way before it has accrued or arisen to the assessee results in the diversion of the income. On the other hand, an obligation to apply income which has accrued or arisen or has been received amounts merely to the apportionment or application of the income and not to its diversion. Sometimes the dividing line between diversion by overriding title and the application of income after it has accrued is somewhat thin.

When income or a portion of income is diverted at the source by an overriding title before it started flowing into the channel which was to reach the assessee concerned it could be excluded from his assessable income. Wherever there is such diversion of income, such diverted income, cannot be included in the total income of the assessee who claims that there has been a diversion. On the other hand, where income has accrued or arisen in the hands of the assessee, its subsequent application in any way will not affect the tax liability.

In order to decide whether a particular disbursement amounts to diversion or application of income, the true test is to probe into and decide whether the amount sought to be deducted, in truth, did not reach the assessee as his own income. It is the nature of the obligation that is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of his income. It is the nature of the obligation that is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of his income. Where, by obligation, income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. In order that there is diversion at source of the income, the obligation is to attach to the source which yields income and not to the income only. This was so held in *CIT vs. Sital Doss Twath 41 ITR 367 (SC), M.K. Brothers Pvt. Ltd. vs. CIT 86 ITR 38 (SC)*. In many cases, it would really be a matter of proper drafting of the document creating the obligation, though, in substance, the result in both the situations may appear similar.

For the purpose of tax planning, the concept of ‘diversion by overriding title’ would have better scope for exploitation than the concept of ‘application of income’. This is because, as pointed out above, where income is diverted by overriding title such diverted income is not taxed in the hands of the person who claims such diversion. On the other hand, the concept of application of income envisages first the accruing or arising of income and when once it has come within the grasp of the Income-tax Act, 1961 it is liable to income-tax whatever may be its destination or whomever it may
be applied for. Therefore if an overriding charge is created by the assessee either voluntarily or in pursuance of an obligation, whether pre-existing or not, the assessee may be able to invoke the principle of diversion of income by overriding charge. This is, of course, subject to the provisions of sections 60 to 64, which have the effect of getting over this principle in some situations.

14.2 TAX PLANNING CONSIDERATIONS IN RESPECT OF SALARY INCOME

The scope for tax planning from the angle of employees is limited. The definition of salary is very wide and includes not only monetary salary but also benefits and perquisites in kind. The only deductions available in respect of salary income are the deduction for entertainment allowance and deduction for professional tax. Therefore, the scope for tax planning in respect of salary income is severely limited. However, the following are some ideas of tax planning in regard to salary income.

(1) **Salary Structure**: The employer should not pay a consolidated amount as salary to the employee. If it is so paid, the entire amount of salary will become taxable without any exemption. Therefore, he can split the same and pay it as basic salary plus various allowances and perquisites.

For example, the employer should include allowances as part of the salary structure of the employees for which exemption can be claimed under Rule 2BB, eg. Children education allowance, hostel allowance, house rent allowance, transport allowance etc. The employer will get a deduction of all the above amounts paid in his assessment.

Further, the employer can give such allowances like special compensatory allowance, border area allowance or remote area allowance or difficult area allowance or disturbed area allowance depending upon the posting of the employee. Some exemptions are available in respect of these allowances. In this connection, Rule 2BB specifies the exempt allowances. The employer has to make a careful study and fix the salary structure in such a manner that it will include allowances which are exempt.

(2) **Employees’ welfare schemes**: There are several employees’ welfare schemes such as recognised provident fund, approved superannuation fund, gratuity fund. Payments received from such funds by the employees are totally exempt or exempt upto significant amounts.

For example, gratuity received by the employee from private sector is exempt upto ₹ 10 lakh. The entire provident fund received by the employee from recognised provident fund is exempt. The employer is well advised to institute such welfare schemes for the benefit of the employees. Such amount contributed by the employer towards the above funds are deductible. However, a note of caution is necessary here in view of the restrictive provisions of section 40A(9) which disallows any contribution made to any welfare funds except where such contributions are
covered by section 36(1)(iv)/(iva)/(v) or as required by or under any other law for the time being in force. In this connection, it may be noted that section 10(23AAA) exempts any income of a staff welfare fund subject to the satisfaction of certain conditions. However, in the absence of an amendment to section 40A(9), contribution to such welfare trusts can be disallowed by the Assessing Officer. Further, the employer can contribute to recognized provident fund account of the employee upto 12% of salary, and the same would not be taxable in the hands of the employees.

(3) Insurance policies: Any payment made by an employer on behalf of an employee to maintain a life policy will be treated as perquisite in the hands of the employee. Further, payments received from the employer in respect of keyman insurance policies constitute income in the hands of the employees. However, the payment of premium by the employer on behalf of the employee will not be treated as a perquisite in the case of accident insurance policies. This is due to the fact that the employer has a vested interest in the safety of the life of his employee who is engaged in such dangerous occupations. [CIT v Lala Shri Dhar (1972) 84 ITR 192 (Del) and CIT v Vinay Bharat Ram (1981) 129 ITR 128 (Del)]. Further, any sum paid by the employer in respect of any mediclaim premium paid by the employee to keep in force an insurance on his health or the health of any member of his family under any scheme approved by the Central Government or IRDA for the purpose of section 80D is not a perquisite in the hands of the employee.

(4) Dearness allowance, dearness pay: The employer should ensure that dearness allowance and dearness pay should form part of “salary”. This is because certain items like entertainment allowance, gratuity, commuted pension and the employer’s contribution to the recognised provident fund etc. are calculated on the basis of salary. Therefore, if dearness allowance, dearness pay etc. are included in salary, the above benefits will also increase leading to higher exemption in the hands of the employee.

(5) Commission: The Supreme Court, in Gestetner Duplicators Pvt. Ltd. v. CIT 117 ITR 1, has held that if, under the terms of employment, commission is payable at a fixed percentage of turnover achieved by an employee such commission should be taken into account for calculating “salary” for the purpose of gratuity etc. The employer will be well advised to provide for such commission.

(6) Leave travel facility: The employer should extend leave travel facility to the employees at all levels. Under section 10(5) of the Income-tax Act, 1961, exemption is provided in the hands of the employee in respect of leave travel concession. Such exemption is available for the employee, spouse, children (to a maximum of 2 children), dependent parents, dependent brothers and dependent sisters.

(7) Rent free accommodation / House Rent Allowance (HRA): An employee should analyse the tax incidence of a perquisite and an allowance, whenever he is given an option, in order to choose the one which is more beneficial to him. In the case of Rent Free Accommodation vs. HRA, it must be noted that the perquisite of rent free accommodation is taxed as per Rule 3(1) of the Income-
tax Rules, 1962 and HRA is exempt to the extent mentioned in section 10(13A) read with Rule 2A. The employee should therefore work out his tax liability and net cash flow under both the options and then, decide on whether to receive HRA or choose a rent free accommodation.

(8) **Medical Allowances:** The employer should avoid paying fixed medical allowance. This is taxable fully. Under clause (v) of the proviso to section 17(2), any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family will be exempt to the extent of ₹ 15,000. The employer can reimburse the employee as above. Further, he can also provide free medical facilities which are not taxable.

(9) **Uncommuted/Commuted pension:** Uncommuted pension is fully taxable. Therefore, the employees should get their pension commuted. Commuted pension is fully exempt from tax in the case of government employees and partly exempt from tax in the case of non-government employees.

(10) **Provident Fund:** Where an employee who is a member of a recognised provident fund and who resigns before completing five years of continuous service should ensure that he joins a firm which maintains a recognised provident fund. The accumulated balance of the provident fund with the previous employer will be exempt from tax provided the same is transferred to the new employer who also maintains a recognised provident fund.

(11) **Retirement benefits:** Incidence of tax on retirement benefits like gratuity, commuted pension, accumulated balance of unrecognized provident fund is lower if they are paid in the beginning of the financial year.

The employer and the employees should mutually plan their affairs in such a way that retirement takes place in the beginning of a financial year.

(12) **Pension received by non-residents:** Pension received in India by a non-resident assessee from abroad is taxable in India. If, however, such pension is first received by or on behalf of the employee in a foreign country and later on remitted to India, it will be exempt from tax.

(13) **Accident insurance:** In respect of accident insurance policies, the decision of the Supreme Court in *CIT v. L.W.Russel (1964)* 53 *ITR* 91 points out that the term perquisite applied to only such sums in regard to which there was an obligation on the part of the employer to pay and a vested right on the part of the employee. If the employee has no vested interest in the policy, it cannot be considered as a perquisite. In view of this position, in cases where an employer takes out accident insurance policy covering all workmen and staff members and pays insurance premium and whenever any worker/staff member meets with an accident and the amount of claim is received from the insurance company and the same is paid away by the employer to the said worker or his family members, the premium paid by the employer in respect of group accident policies could not be considered as a perquisite, under section 17 to be added in the salary income.
of any employee [CIT v. Lala Shri Dhar (1972) 84 ITR 192]. The amount received from insurance company on accident or death by employee or his dependents will not also be in the nature of income but a capital receipt and therefore the same will not be taxable.

(14) **Exempt perquisites**: The following are the perquisites which are exempt from tax–

(i) Use of computers and laptop by employee;

(ii) Medical facility in employer’s own hospital or a public hospital or Government or other approved hospital;

(iii) Educational benefit in a school run by employer provided value of benefit does not exceed ₹ 1,000 per month per child.

(15) **Considerations for salary structuring**: The perquisite valuation rules prescribe the method for valuing the various perquisites provided by the employer to his employees on the basis of the cost of such perquisites to the employee. For a detailed study, students are advised to refer to the chapter on ‘Salaries’. Accordingly, the entire salary structuring for employees will have to be done after carefully weighing the pros and cons of paying cash salary or allowing the benefit of perquisites in kind to the employees.

### 14.3 TAX PLANNING CONSIDERATIONS IN RELATION TO BUSINESS

The scope of income liable to tax under the head “Profits and gains of business or profession” covered by Section 28 to 44D of the Income-tax Act, 1961 has been discussed earlier. The object of this part of the study material is to discuss from the angle of tax planning the various areas in which tax payer will have to take appropriate decisions to ensure that the incidence of tax in respect of his income chargeable under this head is reduced to the extent possible, by taking advantage of the various allowances, deductions and other tax concessions provided under the law.

For a new business, the spheres in which the question of tax planning is relevant are as follows:

(i) Form of the organisation

(ii) Nature of the business

(iii) Financial Structure

(iv) Acquisition of plant and machinery and other fixed assets

(v) Setting up and commencement of business

Each of these aspects will be considered briefly in the following paragraphs. In addition, there is lot of scope for planning with reference to the method of accounting to be employed and the various deductions and special incentives provided under the Income-tax Act, 1961. Certain special tax
planning considerations relevant to specific management decisions, foreign collaboration agreements and other related matters are also discussed.

1) **Form of Business Organisation:** The choice of the appropriate form of business organisation will have to be thought of and decided by the person who intends to carry on business or profession at the beginning itself, because a change in the form of business organisation after the commencement of the business, may attract liability to tax.

A new business can be organised under any of the following forms:

(i) Sole proprietorship
(ii) Hindu undivided family
(iii) Association of persons or Body of Individuals
(iv) Partnership firm/LLP
(v) Company
(vi) Co-operative society

The selection of a particular form of organisation would depend not only on the tax aspect but on other considerations also, e.g., financial requirements and resources, requirement of limited liability and many other practical considerations.

However, depending upon the taxable status and level of tax liability of the owners, a selection can be made from the various forms available for setting up a new unit.

- **Sole Proprietorship:** In the case of a sole proprietorship concern, one of the important tax disadvantages would be that no allowance or relief would be available to the tax payer in computing his income from business in respect of even a reasonable amount of remuneration attributable to the services rendered by him for carrying on the business. As a result, the taxable income arrived at would be a larger amount than what it would have been if it had been the case of, say, a firm paying remuneration to partners, such remuneration is allowable subject to the limits specified in section 40(b)(v). The taxable income from business would get reduced and correspondingly, the incidence of tax would also be reduced.

Under sole proprietorship, the entire income of a business unit gets assessed in the hands of the same person along with other income, while the entire loss and other allowances shall be available for set off in his hands against other income. This may have some advantage in the initial years, after which the possibility of converting it into company/firm may be considered; on such conversion, the questions of possible capital gains tax, etc., will have to be considered.

- **Hindu Undivided Family:** The Hindu undivided family as a unit of taxation continues to exist for the purpose of carrying on business as well and there is a large number of cases where
business is carried on by the members of the family on behalf of the family. Since the law does not specifically provide for the disallowance of such expenses, it is advantageous to carry on a business through the HUF wherever possible. The income of the family is computed and first taxed in the hands of the family at the rates applicable to it. The income of the family may, thereafter, be divided amongst the members of the family and the members, in such cases, do not attract any liability to tax in view of the specific exemption granted under section 10(2) of the Income-tax Act, 1961. Thus, if a business is carried on by a Hindu undivided family, the advantages which are available in the case of a company could be fully availed of and in addition, the members of the family would not become liable to tax when they receive any portion of the family’s income.

♦ **Partnership Firm/LLP:** All firms and LLPs will be taxed at a flat rate of 30%. If the total income exceeds ₹ 1 crore, surcharge @12% would be attracted. Further, education cess @2% and secondary and higher education cess@1% would be applicable. There will be no initial exemption and the entire income will be taxed. In computing the taxable income of a firm, certain prescribed deductions in respect of interest and remuneration have to be allowed. The share income of a firm in the hands of the partners of the firm is fully exempt under section 10(2A).

Also, partnership firms carrying on eligible business can declare income on presumptive basis as per the provisions of section 44AD@8% of gross receipts (6% in case gross receipts are received by an account payee cheque/bank draft/ use of ECS through bank account). Partnership firms carrying on notified profession can declare income on presumptive basis@50% of gross receipts as per the provisions of section 44ADA. In such a case, they need get their books of account audited as per section 44AB.

For a detailed discussion students are advised to refer to Chapter 12 on “Assessment of Various Entities”.

♦ **Company:** For any large venture requiring substantial investment and recourse to borrowed funds from banks and institutions, ordinarily the form of a limited company will have to be adopted. Within the company form of organisation, however, several alternatives exist. On the basis of the ownership and control, a company can either be organised as a widely held company, i.e. a company in which the public are substantially interested within the meaning of section 2(18) of the Income-tax Act, 1961. Alternatively, it can be organised as a closely held company. Depending upon the choice of the form of organisation of the company, the following important tax consequences would have to be considered from the view point of tax planning:

(i) The applicability of provisions of section 2(22)(e) regarding deemed dividend in respect of advances or loans to shareholders would also depend on the fact whether or not it is a company in which the public are substantially interested. The fact that the scope of these provision has been considerably enlarged by the amendments made in section 2(22)(e) from time to time, should also be kept in mind.
(ii) The provisions of section 79 regarding restrictions on carry forward of losses in the event of substantial change in the shareholding of the company also become applicable if the company is one in which the public are not substantially interested. This aspect would assume particular significance in the case of closely held companies where losses are made and shareholdings are transferred before such losses are fully absorbed.

(iii) It is significant to note that domestic companies have to pay tax @17.304% (15% plus surcharge @12% plus cess @3%) on dividend declared, distributed or paid except dividend under section 2(22)(e). For further details students may refer to Chapter 12 on “Assessment of Various Entities”.

(iv) Also, MAT provisions are applicable to companies. It so happens that in case of companies enjoying tax holiday benefits still have to pay tax under MAT provisions, credit of which also cumulated for number of years without being used causing significant outflow of funds in the initial years.

Thus, it can be seen that the concept of deemed dividend under section 2(22)(e) and the provisions of section 79 do not apply to a widely held company.

Place of Effective Management (PoEM) framework is introduced to determine the tax payable by a foreign company that for all purposes is managed from India and yet does not pay tax domestically. Many Indian companies that have traditionally used holding companies and subsidiaries overseas for various reasons are assessing how they may be affected and are racing to put new structures in place before they come under scrutiny. These provisions provide for a foreign company to be a resident of India if the company’s place of effective management is in India. If a company’s POEM is situated in India; it will be treated as Indian resident. Its global income will be taxable in India. It will have to file its tax returns, audit reports etc. with Indian tax department.

Rate of tax: The income-tax rate on foreign companies is higher at 40% plus surcharge @2% (if total income exceeds ₹ 1 crore but does not exceed ₹ 10 crore) and @5%, if the total income exceeds ₹ 10 crore as against 30% (plus surcharge@7%, if total income exceeds ₹ 1 crore but does not exceed ₹ 10 crore and @12%, if total income exceeds ₹ 10 crore) on domestic companies. This is so because distributions by the former are generally not liable to tax in India. Furthermore, domestic companies having total turnover or gross receipt not exceeding ₹ 50 crore in the P.Y.2015-16 enjoy a concessional rate of tax@25% in the A.Y.2018-19. Also, certain tax incentives available to domestic companies are not available to foreign companies. Some instances are amortisation of preliminary expenses, expenditure on prospecting for minerals, export incentives, incentives in respect of foreign projects profits, earnings in convertible foreign exchange, tax holiday profits of ships, hotels,
etc. It is advantageous, from tax angle, for foreign corporations intending to do business in India to do so through a subsidiary instead of directly through a branch.

- **Co-operatives:** The co-operative form of business organisation, i.e., a co-operative society would also be advantageous from the tax angle and, in addition to the general benefits flowing from the co-operative form the society, can claim deduction in respect of the reasonable amount of remuneration payable to the members of the society for their services rendered, including the amount of commission, if any payable to them and the interest on the deposits or loans given by them. The co-operative society is entitled to a further tax benefit arising from section 80P under which the income of a co-operative society is exempted from tax under different circumstances depending upon the nature of the income and/or the amount thereof. In addition to the various tax concessions which are available to all assessee, the co-operative society stands to gain substantially by virtue of the special benefits available to it under section 80P. The profits of the society remaining after payment of tax would be distributed by it amongst its members in the form of dividends subject to the relevant legislation.

However, it may be noted that benefit under section 80P has been withdrawn w.e.f. A.Y.2007-08 in respect of all co-operative banks, other than primary agricultural credit societies (i.e. as defined in Part V of the Banking Regulation Act, 1949) and primary co-operative agricultural and rural development banks (i.e. societies having its area of operation confined to a taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities). This is for the purpose of treating co-operative banks at par with other commercial banks, which do not enjoy similar tax benefits.

From the above analysis of various forms of the organisation and their treatment for income-tax purposes, it may be appreciated that the provisions of the taxation laws have a considerable influence on the entrepreneurs in their choice of particular form of the organisation that they should establish.

**Illustration 1**

Mr. Gavaskar sought voluntary retirement from a Government of India Undertaking and received compensation of ₹ 40 lacs on 31st January, 2018. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of ₹ 15 lacs, which would carry interest at 8% p.a. Gavaskar’s wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of ₹ 5 lacs. Mr. Gavaskar would like to draw a monthly remuneration of ₹ 40,000 and also interest @10% p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business.

**Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required.**
Solution

The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:

(i) In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b). Remuneration and interest should however, be authorised by the instrument of partnership and paid in accordance with such instrument. Such interest and salary shall be taxable in the hands of partners to the extent the same is allowed as deduction in the hands of the firm under section 40(b). Interest to partners can be allowed upto 12% on simple interest basis, while the limit for allowability for partners' remuneration is based on book profit under section 40(b). As per section 40(b)(v), partners' remuneration shall be allowed to the extent of aggregate of -

(a) On the first ₹ 3,00,000 of book profit or in case of loss – ₹ 1,50,000 or at the rate of 90% of book profits, whichever is more

(b) On the balance of book profit – at the rate of 60%

(ii) Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).

(iii) If a proprietary concern is formed, the salary of Mrs. Gavaskar shall be allowed as deduction under section 37(1).

(iv) The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of ₹ 5 lacs is justified in view of her long experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.

(v) An issue arises as to whether remuneration of Mrs. Gavaskar would be includible in the total income of Mr. Gavaskar. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. However, the clubbing provision does not apply if the spouse possesses technical or professional qualification and the income is solely attributable to the application of his or her technical or professional
knowledge and experience. Further, technical or professional qualification would not necessarily mean the qualifications obtained by degree or diploma of any recognized body [Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)]. The experience of Mrs. Gavaskar as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.

(vi) If Mrs. Gavaskar joins the proprietary concern or partnership concern of her husband as employee, remuneration of ₹ 5 lacs shall be taxed in her hands under the head "salary".

(vii) If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).

(viii) The tax rate applicable to an individual depends on the level of his/her income, whereas for partnership firms it is flat rate at 30%. Surcharge@12% would be attracted only if total income exceeds ₹ 1 crore. For individuals, the rate of tax is 5% on income exceeding ₹ 2.50 lakhs but not exceeding ₹ 5 lakhs, 20% for total income exceeding ₹ 5 lakhs but not exceeding ₹ 10 lakhs and @30% in respect of income exceeding ₹ 10 lakhs for the assessment year 2018-19. The surcharge for total income exceeding ₹ 50 lakhs but not exceeding ₹ 1 crore is 10% and for total income exceeding ₹ 1 crore is 15% of tax payable. Education cess@2% and Secondary and higher education cess@1% is attracted in both the cases.

(2) **Nature of the business**: Besides the form of organisation, the choice of the nature of the business also calls for appropriate planning with reference to the various special benefits available under the taxation laws to the particular kinds of industries which are not available to other kinds. Some of these benefits are of such a substantial nature that they constitute one of the major factors in the determination of the nature of the business.

Broadly, business for this purpose may be divided into two categories—trading and manufacturing business. There could be a third category involving combination of both. Deduction is available under section 10AA to newly established units in Special Economic Zones.

A taxpayer carrying on manufacturing or industrial activities would be in a position to avail of the various concessions such as depreciation allowance, benefit of amortisation under sections 32, 35ABA, 35ABB, 35D and 35E.

Tax holiday benefit under section 80-IAC would be available in case of eligible start-up, under section 80-IBA in case of developing and building housing projects and under section 80LA in case of offshore banking unit and IFSC located in Special Economic Zone.

While deciding the nature of the business, the benefit of tax exemption or concessional treatment available in respect of certain types of income such as agricultural income, new industrial undertakings, ships, business of repairs to ocean going vessels, business of exploration, etc. of mineral oils, etc. should also be taken into account.
(3) **Sources of Funds or Financial Structure**: Broadly speaking, the choice in the matter of financing a new unit or business would be between capital and borrowings. New units being set up by existing units or companies would have the possibility of using retained profits. In the case of a company, the means of finance are as follows:

(i) Share capital.

(ii) Debentures.

(iii) Other borrowed moneys.

(iv) Generation of funds through profits.

While the return on share capital is a charge on the profits after tax, the return on loans to the lenders is a charge on the profits before tax. Thus, recourse to borrowings would offer a tax advantage which will be reflected in a higher rate of return on the owner’s capital.

(4) **Acquisition of Fixed Assets**: Apart from other considerations relevant in the context, the consequences may require a careful choice between buying or leasing some or more of the fixed assets. Assets can be bought or hired. If these are bought and are depreciable, e.g. building, plant and machinery and furniture, the assessee can claim depreciation on the cost and over the years. The entire cost can be claimed as deduction against the profit. If hired, however, the charge for hire becomes an admissible deduction. Having regard to the fact that the acquisition of an asset requires a larger immediate outlay than what is necessary in the case of hiring, the company may opt for hiring in some cases rather than for straight acquisition. For example, taking the business premises on rent rather than purchasing the same may be a better proposition.

But in the case of plant and machinery, two additional considerations may arise. New plant and machinery in certain industries may enable a company to claim deduction on account of depreciation and additional depreciation which may outweigh other considerations. Similarly, if there can be a new industrial undertaking, substantial tax benefits may be available by way of tax holiday benefit, etc. but that would require employment of new plant and machinery to a large extent. These considerations are out and out tax considerations which may prompt an assessee to make two choices—(i) not to hire plant and machinery but to purchase them and (ii) not to purchase second hand plant and machinery but to purchase them new.

In appropriate cases, the assessee may go in for second hand imported plant and machinery, satisfying the conditions laid down. In cases where an assessee opts to go for old plant and machinery, the limit regarding the use of old plant and machinery, as laid down in Section 80-IAC should be taken into consideration. Difficulties may arise in applying the 20% limit for the value of old plant or machinery for the purpose of section 80-IA etc. since the concept of value to be adopted for this purpose has not been spelt out in the law and it is not clear whether such value should refer to the cost or market value or the written down value as per books or as per income-tax records. Particular care will have to be taken while planning for such a situation.
The assessee engaged in the specified business mentioned in section 35AD can avail the benefit of deduction of capital expenditure incurred wholly and exclusively of the purpose of such specified business. Capital expenditure incurred prior to commencement of business shall be allowed as deduction during the previous year in which the assessee commences operation of the specified business if, such expenditure incurred is capitalized in the books of accounts of the assessee on the date of commencement of its operation. However, such deduction is not available in respect of capital expenditure incurred on acquisition of any land, goodwill or financial instrument. In case the deduction under this section is claimed, no deduction shall be allowed under Chapter VI-A under “Deduction in respect of certain incomes” in relation to the specified business for the same or any other assessment year.

(5) Setting up and commencement of production: Setting up of business in the context of the Income-tax Act, 1961 is a concept entirely confined to that Act. It is not the same as the commencement of the business and these two concepts have been clearly distinguished for income-tax purpose. Between the date of the setting up and date of commencement, there may be an interregnum during which the assessee may be incurring expenses of a revenue nature.

Under the taxation laws, the expenditure incurred prior to the date of setting up is not normally admissible for income-tax purposes. But if those are incurred on and from the date of setting up, but before commencement of the business, they may be allowed as deduction for tax purposes provided of course they are revenue in nature and are incurred wholly and exclusively for the purposes of business.

It is now practically well settled by various judicial rulings that a business is set up as soon as it is ready to commence production and it is not necessary that actual production should be so commenced. Thus, in the case of a company established for manufacturing cement, the business is set up as soon as acquiring of limestone is commenced even if at that time the plant and machinery may not have been installed so that actual manufacturing operations may commence.

A tax planner should accordingly fix the setting up date in such a manner that the company gets the maximum scope for allowability of expenses incurred contemporaneously to the date of setting up remembering that if those are incurred prior to the setting up date those are inadmissible as direct deductions while, if such expenses are of a revenue nature and they are wholly and exclusively incurred for business purpose, and are incurred subsequent to the date of setting up, they will be admissible as normal deductions. The following examples may be noted:

(a) Such expenditure may be allowed as revenue expenditure. Expenditure by way of brokerage, legal charges, etc. for arranging long term loans, interest on borrowing— India Cement Ltd. vs. CIT 60 ITR 52 (SC).

(b) Such expenditure may form part of the cost of assets on which depreciation may be available - Challapalli Sugars Ltd. vs. CIT 98 ITR 167 (SC).
In this context, the provisions of *Explanation 8* to Section 43(1) to the effect that any interest paid or payable in connection with the acquisition of an asset, which is relatable to any period after such asset is first put to use cannot be capitalised, are relevant.

(c) Such expenditure may constitute preliminary expenditure and may be eligible for amortisation over a ten year or five year (as the case may be) period under section 35D.

(d) Such expenditure, if being of a capital nature and if not falling under any of the three categories noted above may be disallowed and there may not be relief either on account of depreciation or amortisation.

6. **Tax planning for business deductions — Some general considerations:** There are several matters which affect the assessee’s ability to deduct various expenses for income-tax purposes. Some of the principal considerations to be borne in mind planning for business deductions, are given below:

Successful tax planning for business deductions pre-supposes a clear and thorough understanding of the various statutory provisions governing the deductions and an awareness of the statutory rights as well as various restrictions and conditions governing such rights. The general considerations applicable to tax planning in the field of business deductions, revolve round their-

(a) allowability.

(b) year of allowability.

(c) extent of allowability (disallowing provisions if any), and

(d) carry-forward to future years.

Often, the question of expenditure being capital or revenue and the consequences attaching to the likely treatment eventually may also be an important part of the tax planning exercise. This aspect has been discussed at a later stage.

One of the important aspects of tax planning would be to see that the maximum deduction or allowance is obtained in the earliest possible time for the purpose of determination of taxable income. Therefore, while deciding about incurring of capital and revenue expenditure, the assessee should consider the tax treatment of such expenditures and the period within which the benefit of deduction or amortisation would be obtained so that he can estimate and work out cash flow position over a period of time. While tax considerations play a major role in investment decisions, the general principles of financial management and their effect on investment decisions should not be ignored.

The tax planner should keep in mind the advantage arising out of minimising the expenditure, especially in the initial years of a business, so that the profits may be maximised and the assessee may be in a position to avail of the various tax incentives like depreciation as also the tax holiday
provisions.

Normally, deductions of expenditure are allowable in the year in which it is incurred or paid depending on the method of accounting followed, viz, mercantile or cash. In other words, the expenditure to be claimed as deduction should be claimed in the relevant year. Where the assessee follows the cash system of accounting, the allowance in respect of expenses would be available only when the moneys in respect of them are actually paid by the assessee. Whereas in the case of mercantile system of accounting, if a business liability has definitely arisen in the accounting year, a deduction should be allowed. Where accounts are kept on a mercantile basis, if an expenditure is claimed on the ground that it is legally deductible, it can be claimed in the year in which the liability for the expenditure is incurred even though the payment itself is made in a subsequent year. If an assessee following mercantile system fails to claim an expense in the year in which it accrues he loses the right to claim it as a deduction altogether. He cannot claim or make any attempt to reopen the accounts of the earlier year to which the expense relates.

The Supreme Court's decision in *C.I.T. vs. Gemini Cashew Sales Corporation* (1967), 651 T.R. 642 emphasizes the principle that if the liability to make the payment has arisen during the previous year, it must be appropriately regarded as the expenditure of that year and merely because the payment in respect of the expenditure is made in the subsequent year, the assessee would not be entitled to claim deduction in respect thereof in the subsequent year. As pointed out earlier, this is subject to the provisions of section 43B.

Normally, deduction can be claimed by the assessee only in respect of those expenses and losses which have been actually incurred by the assessee during the previous year, i.e. after the business is set up. However, there are some exceptions to this rule and a tax planner should be aware of the exceptions and make use of them in appropriate cases. For example, expenditure incurred on scientific research before the commencement of the business — capital or revenue during the three years immediately preceding the commencement of the business and coming within the scope of the *Explanation* to sections 35(1)(i) and 35(1)(ii), capital expenditure incurred prior to commencement of specified business allowed as deduction in the year of commencement of business, in case capitalized under section 35AD, preliminary expenses incurred before commencement of the business and coming within the scope of section 35D, expenditure on prospecting for minerals coming within the scope of section 35E, are cases where the assessee could claim deduction in respect of the expenditure even though the expenditure was not incurred during the previous year.

Similarly, the expenditure in respect of which deduction is claimed by the assessee should not be in the nature of capital expenditure. This is again subject to the statutory exceptions contained in provisions like section 35 and 35AD. Again, subject to the statutory exceptions, the expenditure should be incurred wholly and exclusively for the purpose of the business.

Various other expenses incurred prior to the commencement of commercial operations may, in appropriate cases, be accumulated and capitalised by being spread over the cost of various assets constructed or acquired during the pre-production period. If this is done on a proper basis, the cost
of the various assets including the indirect expenses capitalised can be depreciated for tax purposes to the extent that the cost relates to assets which are themselves depreciable for income-tax purposes. This is a matter which the tax planner should bear in mind in order to ensure that expenses incurred during the construction period are properly accounted and allocated.

**Interest on borrowed capital**

Under clause (iii) of section 36(1), deduction of interest is allowed in respect of capital borrowed for the purposes of business or profession in the computation of income under the head “Profits and gains of business or profession”. As per the proviso to section 36(1)(iii), any amount of interest paid, in respect of capital borrowed for acquisition of an asset for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

ICDS IX on Borrowing Costs deals with the treatment of borrowing costs. It requires borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset to be capitalized as part of the cost of that asset.

Qualifying asset has been defined to mean –

- land, building, machinery, plant or furniture, being tangible assets;
- know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;
- inventories that require a period of twelve months or more to bring them to a saleable condition.

This ICDS requires capitalization of specific borrowing costs (in respect of funds borrowed specifically for the purpose of acquisition, construction or production of a qualifying asset) and general borrowing costs. In case of qualifying assets being tangible and intangible assets, the capitalization shall commence from the date on which funds were borrowed and cease when such asset is first put to use.

This ICDS also provides the formula for capitalization of borrowing costs when funds are borrowed generally and used for the purpose of acquisition, construction or production of a qualifying asset. For this restricted purpose, a qualifying asset shall be such asset that necessarily require a period of 12 months or more for its acquisition, construction or production. In this case, the capitalization of borrowing costs shall commence from the date on which funds were utilized.

**Thin Capitalisation Rules**

Equity and debt are the two ways through which a company can source its funding. ‘Thin capitalisation’ refers to a situation where a company is financed through a substantially higher amount of debt than equity. The capital structure of a company has consequential effects on the amount of profit it reports for tax purposes. The Act allows a deduction on interest paid or payable
for arriving at taxable profit while dividend paid on equity is not deductible. Therefore, a higher level of debt entails lower levels of taxable profit, thereby providing an incentive to finance operations with debt rather than equity. Companies structure their mix of finance in such a way that they maximise the benefit of claims of deduction of interest. The Finance Act, 2017 has sought to restrict interest expenses claimed by an Indian company or a permanent establishment of a foreign company on payments to its non-resident associated enterprises (or a permanent establishment thereof) to 30% of earnings before interest, taxes, depreciation and amortization. With a view to targeting only large interest payments, this provision would be applicable only in cases where the interest expense exceeds ₹ 1 crore. Banks and insurance companies have been exempted from these provisions.

**Specific deductions under the Income-tax Act, 1961**

The Income-tax Act, 1961 lists several specific deductions. A deduction falling under each category is allowable subject to the conditions and limitations, if any which may be specified. At times the restrictive conditions apply to expenditure which is prima facie suspect as, for example, transactions with relatives or associates or within the same group coming within the scope of section 40A(2). While planning for business deductions, due regard must be had to these limitations.

In addition to the specific provisions the omnibus provision in section 37 also enables an assessee to claim deduction in respect of expenditure laid out ‘wholly and exclusively for the purpose of the business’ the tax planner has to take into consideration the principles emerging from the innumerable relevant judicial rulings while availing of the facility of deduction under this provision. Any expenditure incidental to business, may be deducted except those prohibited by any provision of the Act.

Ordinarily, an expenditure which is specifically provided for should be claimed under the relevant section rather under the omnibus provision. To justify the deduction under the residual clause, all that is required is that the expenditure must have been incurred wholly and exclusively and it is not necessary to prove that the expenditure was also incurred ‘necessarily’ or ‘reasonably’. The expenditure must have been incurred ‘for the purpose of business’. These words are wider than the phrase “for the purpose of earning profits”. A specific quid pro quo is not essential. It is not necessary to show that the expenditure resulted in commensurate benefit or advantage either during the same year or subsequently.

An expenditure is liable to be disallowed if it is either of a personal nature or of a capital nature. The question whether a particular expenditure is of a personal nature must be judged by reference to the assessee himself and not any other person.

- **Capital or Revenue:** Generally speaking, an expenditure is regarded as being of a capital nature, if it results in the acquisition of an asset or of an advantage or benefit of an enduring nature.
The test with regard to the nature of the expenditure—capital or revenue—is to be applied with reference to its purpose rather than its effect. The test must be applied by reference to the assessee himself and not any other person. For instance, a company must be obliged to construct pipelines for the purpose of its business but under conditions whereby the pipelines ultimately become the property of a municipal corporation rather than the company itself. In such a case, although the pipelines undoubtedly constitute tangible assets the expenditure may not be regarded as of a capital nature, since the assets do not belong to the company but to some other person. There are many judicial rulings to support this view. A leading case that maybe referred to in this context is *Lakshimi Sugar Mills Co. P. Ltd. vs. CIT*, 82 ITR 376.

If the purpose of the expenditure is to secure a commercial advantage, rather than acquisition of a capital asset, it is likely to be allowed as revenue expenditure even though the advantage may endure for an indefinite period. However, this rule is by no means inflexible or capable of universal application. Conversely, if the purpose of the expenditure is the acquisition of an advantage or benefit of an enduring nature the expenditure is liable to be treated as capital expenditure even if the period or durability of the asset acquired as the result of the expenditure is very short. For example, if a company making shoes acquires knives and lasts, whose life is only three years, the expenditure may nevertheless be regarded as capital expenditure.

In applying the various case laws on the subject of distinction between capital and revenue, it should be recognised that circumstances do change and the law normally keeps pace with such changing circumstances. The expenditure that was regarded as capital expenditure resulting in long-term benefit during the relatively *laissez faire* days of the 19th century may not perhaps, be regarded as capital expenditure in the context of the rapid technological changes which are the feature of industrial life today. The decision of the Supreme Court in *Shahzada Nund & Sons vs. CIT*, 108 ITR 358 also supports this view. A tax planner would do well to keep track of the various cases reported from time to time so as to keep himself informed of the trend of judicial thinking in this regard.

In this context, the requirements spelt out in the various income computation and disclosure standards have also to be kept in mind while considering the point in time of deductibility of expenditure.

**Expenditure specifically allowed:** The Income-tax Act, 1961 specifically allows many types of expenditure such as depreciation, expenditure on scientific research, expenditure on know-how, preliminary expenses, bad debts etc. The Act prescribes several conditions and restrictions for the allowance of such expenditure. The tax-planner should take care to see that all the prescribed conditions are complied with so that deductions may not be denied.
Other business expenses: As already explained earlier, section 37(1) deals with the various items of expenses which are otherwise not covered by the provisions of Section 30 to 36 of the Income-tax Act, 1961 and specifically provides that all expenses which are incurred wholly and exclusively (though not necessarily) for the purpose of the business or profession carried on by the assessee would be deductible in computing the assessee’s business income. In order to qualify for deduction under this provision, the following important conditions will have to be fulfilled:

(i) The expenditure should have been incurred by the assessee in the ordinary course of his business or profession;
(ii) The expenditure should be of a revenue nature and should not be of capital nature;
(iii) The expenditure should not be of a personal nature;
(iv) The expenditure should not be covered by any other provisions of sections 30 to 36 for purposes of allowance and it should not also be covered by any of the provisions of disallowance contained in sections 40 to 44D; and
(v) The expenditure should not be one which is in the nature of an appropriation of income or diversion of profits by an overriding title. It should not also be one in respect of which deduction is permissible under Chapter VI-A of the Income-tax Act, 1961 from the gross total income of the assessee.

Commercial expediency: The concept of ‘commercial expediency’ helps a tax payer in insisting that a reasonable view is taken of his right to deduct normal expenditure. The trend in judicial thinking has also recognised this concept. This concept reflects the fact that it is virtually impossible for the legislation to list all possible deductions to which an assessee would be entitled in computing his taxable income and therefore the fact that a business has to be run by the assessee himself under normal commercial conditions must be recognised in determining the allowability of certain expenditure. The test of commercial expediency should be applied from the point of view of a normal prudent businessman, by reference to modern concepts of business responsibility and not by reference to the subjective standards of the revenue department.

A claim on the ground of commercial expediency is subject to the under-noted conditions and limitations:

(a) If the expenditure is covered by one of the express provisions in the Act, it must conform to the requirements stipulated therein.
(b) An expenditure which is expressly disallowed under the Act cannot be claimed on grounds of commercial expediency.
(c) An expenditure cannot be claimed on grounds of commercial expediency if it is improper or illegal. It may be commercially expedient to pay a bribe or incur a penalty but this does not mean that the bribe or penalty would be normally deductible for tax purposes.

There is also a distinction between a payment made for a violation or breach of law and payment made for a breach of contract. Courts have taken the view that where the payments are not in the nature of penalties for infraction of any law but made in pursuance of the exercise of an option given in a particular scheme and where the assessee opts for it out of commercial expediency and business consideration, it could be allowed as deduction. For instance, payments made to Export Promotion Council for shortfall in export performance and payment made to Cotton Mills Federation for non-import of allotted quota of requisite cotton, etc. were held to be allowable as payments falling in this category [CIT vs. Manekia Harilal Spg & Mfg. Co. Ltd. (1991) 7 Taxman 395 (Guj), CIT vs. Raj Kumar Mills. Ltd. (1982) 135 ITR 812 (M.P.) CIT vs. Vasanth Mills Ltd. (1979) 120 ITR 311 (Mad.)] and other cases.

**Impact of Income computation and disclosure standards (ICDSs) on income computation**

Income Computation and Disclosure Standards (ICDS) were developed with a view to reduce tax related disputes by bringing consistency in the application of accounting principles in governing the computation of income.

Sec. 145(2) of the Income-tax Act, 1961 empowers the Central Government to notify income computation and disclosure standards (ICDSs) to be followed by any class of assessees or in respect of any class of income.

Accordingly, the Central Government had, vide Notification No. S.O. 892(E) dated 31.3.2015, in exercise of the powers conferred by section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “Income from other sources”. This notification was to come into force with effect from 1st April, 2015, to be applicable from A.Y. 2016-17.

However, the Central Government has, vide Notification No. S.O. 3078(E) dated 29.9.2016, rescinded Notification No. S.O. 892(E) dated 31.3.2015. Simultaneously, vide Notification No. S.O. 3079(E) dated 29.9.2016, the Central Government has notified ten new ICDSs to be applicable from A.Y. 2017-18 and also made suitable changes to tax audit forms vide Notification No. 88/2016.

The CBDT has, vide Circular No.10/2017, clarified certain issues on ICDS notified u/s 145(2) of the Act. The deviations in ICDSs vis-à-vis ASs would also increase the timing differences between taxable income and accounting income. Further, the ICDSs, at many places, differ significantly from decisions pronounced by the Supreme Court and High Courts.

The significant deviations between the Accounting Standards and the ICDSs clearly indicate that
the overall impact of ICDSs is the advancement of recognition of income and gains and postponement of recognition of expenses and losses. Consequently, timing differences between taxable income and accounting income would increase. Many of the ICDSs also tend to deviate significantly from the decisions pronounced by the Apex Court and High Courts recognizing accounting principles under tax laws.

(7) **Tax consideration governing Management/Investment decision**: Though management/investment decisions are not based on the tax factor alone, yet it has become imperative to consider tax factors before adopting any course of action because the effect of this factor is not only significant but it may also differ from one alternative to another. To illustrate this point, tax implications that are relevant while taking some specific management decisions are explained below:

◆ **Make or buy decision**: In making ‘make or buy’ decisions, the variable cost of making the product or part/component of product is compared with its purchase price in the market. The article is brought if the former is greater than the latter. Alternatively, if the decision to make involves establishment of a separate industrial unit for this purpose, a decision may be taken on the basis of total cost rather than variable cost. In such an event, the assessee would also be in a position to get the tax benefits arising from allowances such as depreciation, tax holiday benefit and deduction in respect of profits from new industrial undertakings, wherever they are applicable.

There are many other costing and non-costing considerations which are kept in mind at the time of taking the decision, like capacity utilisation, supply position of the article to be bought, terms of purchase, etc. The basis of taking make or buy decision should be ‘saving after tax’. The net saving can be ascertained after deducting from gross savings, income-tax payable on the amount of saving. The long-term advantages arising out of a decision to make should also be given due weightage in arriving at a decision.

At the time of ascertaining variable cost of the product (for taking make or buy decision) all taxes such as excise duty, import duty, customs duty, octroi etc., payable in the process of manufacture should be taken into account and in determining purchase price of the product. All taxes to be borne by the purchaser such as sales tax, local taxes should be added for the purpose of comparison and cost of purchasing.

◆ **Own or lease**: Another important area of decision making is whether to own or lease (or sale and lease back). There are advantages as well as disadvantages in leasing. Leasing avoids ownership and with it, the accompanying risks of obsolescence and terminal value losses. In leasing, immediate payment of capital costs is avoided but fixed rental obligation arises. There are many factors which are required to be considered before making ‘own or lease’ decision such as cost of asset to be owned, rent of the asset to be taken on lease, source of financing the asset, risk involved in the alternatives, impact of tax concessions such as depreciation, tax holiday benefit, etc.
Leasing can also provide important tax advantages. If the asset is taken on lease, the firm can deduct for income-tax purposes, the entire rental payment. If the rate of tax is 30%, then, the effective rent obligation is reduced to that extent. Another tax advantage of the lease is that the life of the lease can be shortened compared to the depreciable life otherwise allowed if the assessee purchased the asset. Thus, there is a delay in paying taxes and in effect an interest free loan by the Government to the extent of the delay in taxes. There is one more tax advantage arising out of lease which arises from the opportunity to depreciate otherwise non-depreciable assets. The principal asset of this type is land. The lease rental covers the cost of the land which thus becomes deductible. This arrangement may prove particularly attractive where the land value constitutes a high percentage of the total value of the real estate or where the building is already fully depreciated. Leasing is becoming popular in India.

Wherever possible or appropriate, the concept of sale and lease back can also be made use of as a tool for tax planning with its attendant advantages.

♦ **Lease rent paid:** As regards the consideration for the lease, there could be two types of receipts in the hands of the lessor-receipt on capital account termed ‘premium’ or ‘salami’ in respect of the transfer of rights and receipts on revenue account termed ‘rent’ for the right or liberty to use the property for a term of years.

The lease rental paid is chargeable to revenue every year. The lease rental may be split into three components—the recovery of principal, cost, the interest chargeable and an element of profit. It is generally believed that the interest rate in-built into the rent would be more than the going market interest rate for term loans for purchase of equipment. Since the entire lease rental is chargeable to revenue the lessee could claim tax benefits on even the principal investment in the equipment. Tax advantage in such cases is reported to be more in a leasing transaction than in a similar loaning transaction.

♦ **Retain or Replace Decision:** One of the important decisions which involves alternative choice is whether or not to buy new capital equipment. Both have their own merits and demerits. Generally, replacement offers cost saving which results in increase in profit. However, replacement requires investment of large funds resulting in extra cost. The decision is based on the relative profitability and other financial and non-financial considerations. Tax considerations should also be taken into account in this context. Some of the important considerations from the tax angle to which attention will have to be paid relate to the allowance of depreciation, as also the allowance on account of expenditure on scientific research. The applicability of the provisions for allowances should be considered and their impact ascertained before any decision is taken.

(8) **Tax Planning with reference to Foreign Collaborations:** Very often, Indian concerns enter into foreign collaboration agreements. The tax implications of these agreements both on the
foreign party and on the Indian concern are required to be known in advance. The foreign collaborator wants to make sure about his tax liabilities in India and unless assured of involvement with a not too high amount of tax, the foreign party is not very eager to conclude an agreement with an Indian party. In such a case, the foreign collaborator can seek advance ruling under the provisions of Chapter XIX-B of the Income-tax Act, 1961, for determination of tax implication of the transaction to be undertaken by the non-resident applicant. The Indian party must examine all the tax angles and devise a method which will saddle the foreign collaborator with the minimum amount of tax in India. The aim should be to arrange the affairs in such a way within the four corners of the law so as to attract the minimum amount of tax.

- **Double Taxation Avoidance Agreements**: For the determination of the taxability of foreign collaborators, the provisions of section 90 are very relevant. This provision empowers the Central Government to enter into double taxation avoidance agreement with foreign countries. In exercise of this power, the Government has entered into such agreements with a number of foreign countries.

Where there is an agreement between the Government of India and the Government of a foreign country, the tax liability of the foreign participant is determined in accordance with and subject to the provisions of the agreement and the Income-tax Act, 1961, to that extent, stands superseded by such agreement. In fact, *Circular No. 333 dated 2.4.1982*, issued by the CBDT clarifies that where a double taxation avoidance agreement provides for a particular mode of computation of income the same should be followed irrespective of the provision of the Income-tax Act, 1961. Where there is no specific provision in the agreement, it is the basic law, i.e., the Income-tax Act, 1961 which will govern the taxation of income.

Generally, the foreign party happens to be a non-resident for tax purposes. The status in which the chargeability to tax usually arises in the hands of the foreign party is either that of a company, or of an association of persons or of an individual. Body corporates incorporated outside India are treated as ‘companies’ for the purposes of section 2(17)(ii).

- **Advance Rulings**: In appropriate cases, the facility of getting Advance Rulings, envisaged by section 245N-245V could also be availed of.

- **Double taxation relief**: Taxpayers deriving income chargeable to tax both in India and in a foreign country by virtue of their business being carried on in more countries than one or otherwise, should avail of the benefit of double taxation relief granted under sections 90, 90A and 91 of the Income-tax Act, 1961 subject to GAAR provisions in Chapter X-A of the Act. In order to get the benefit of relief, before starting to carry on business operations in a foreign country, the assessee should be certain whether India has entered into a double taxation avoidance agreement with the foreign country and, if so, the extent to which and the manner in which the relief has to be availed of. Taxpayers should prefer to derive income from those countries with which India has entered into agreement for granting relief from double taxation as compared to those countries with which no such agreement exists. Even in cases where the income is derived from a country with which India has not entered into double taxation
avoidance agreement, the assessee should claim the unilateral relief available under section 91 by proving that he has paid tax in that country on the income which accrued or arose there during the previous year. In such a case, he would be entitled to a deduction from the Indian-tax-payable by him, of a sum calculated on such doubly taxed income at the Indian rate of tax or at the rate of tax of the concerned country, whichever is the lower, or at the Indian rate of tax, if both the rates are equal. The claiming of this statutory relief would help to reduce the total incidence of tax on such doubly taxed income. However the arrangement’s main purpose should not be to obtain a tax benefit, thus, not void of commercial substance and should not result in abuse/misuse of the provisions of the Act.

Another aspect which will require consideration is the effect of double taxation avoidance agreements wherever they exist. To the extent specific provisions exist in such agreements, the corresponding provisions in the national law will not have application. Therefore, in understanding the tax liability in respect of technical tie-ups with foreign parties, attention will have to be paid to the relevant provisions of the double taxation avoidance agreements vis-à-vis the provisions of the Income-tax Act, 1961.

(9) Tax planning in case of losses: The provisions of sections 70, 71 and 72 of the Income-tax Act, 1961 regulate the manner in which losses incurred in the business carried on by any taxpayer will have to be dealt with for tax purposes. The consideration to be given by taxpayers in the matter of taking the full benefit of set-off of losses permissible under the law is as important as the considerations for tax planning which are taken into account in regard to business expenses or claiming the maximum allowances and deductions particularly in view of the fact that the provisions of set-off of losses offer valuable scope for planning.

Under section 73, losses incurred in speculation business are to be set off only against the income from the business of speculation, if any, which the assessee may derive in the same year or in the subsequent four years. In view of the prohibition in the matter of set-off of losses incurred in speculation business, it would be in the interest of the assessee to avoid indulging in the business of speculation if it is likely to result in losses and there is no possibility of setting it off against future speculation profits within the specified period. Where the business of speculation carried on by the assessee is not profitable, he could discontinue the business of speculation in the same line so that the quantum of losses could be reduced and the assessee could resort to speculation in any other profitable field thereby taking the benefit of exception provided under the law.

Loss from specified business referred to in section 35AD can be carried forward indefinitely under section 73A for set-off against income from the same or any other specified business. Such loss cannot, however, be set-off against income from non-specified business or income under any other head.

The Supreme Court, in *CIT vs. Shanti P. Ltd.* (1983) 145 ITR 57, held that a transaction cannot be described as a ‘speculative transaction’ within the meaning of section 43(5), where there is a
breach of a contract and on a dispute between the parties, damages are awarded as compensation by an arbitration award. However, where there is no dispute and damages on a pre-determined basis are payable under the contract, without actual delivery of the goods contracted for, the transaction would be a speculative one. If any loss arises out of such a speculative transaction, such speculation loss would not be available for adjustment against other business profits, if any.

The assessee should exercise his right of set off of brought forward loss at the first available opportunity. The Madras High Court, in Tyresoles (India) vs. CIT [1963] 49 ITR 15, held that where losses sustained are not set off against the profits of the immediately succeeding year or years, they cannot be set off against profits at a later date. This has been followed by the Punjab and Haryana High Court in B.C.S. Kartar Chit Fund and Finance Co. (P.) Ltd. vs. CIT [1989] 79 CTR (P & H) 232. Hence, as a matter of proper tax planning, the assessee should exercise the right under section 72 in the immediately succeeding year/years when the profits allow such a set off.

It is also significant to note that under section 79, a closely held company will not be entitled to claim the benefit of carry forward and set-off of losses, if shares carrying at least 51% of the voting power is not held on the last day of the previous year by the same persons who held such shares on the last day of the previous year in which the loss was incurred. A closely held company, eligible for deduction under section 80-IAC will not be entitled to claim the benefit of carry forward and set off of losses, if all the shares are not held on the last day of the previous year by the same persons who held such shares on the last day of the previous year in which the loss was incurred and such loss should have been incurred during the seven years beginning from the date of incorporation of such company. This benefit will not be denied if the change has occurred on account of death of a shareholder or on account of transfer by a shareholder to his relative by way of a gift. This benefit will also not be denied if the change in shareholding of an Indian company, which is a subsidiary of a foreign company, is the result of an amalgamation or demerger. However, this is subject to the condition than 51% shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or resulting foreign company. It should be kept in mind that section 79 applies to carry forward and set off of losses and not to the benefit of deduction in respect of unabsorbed depreciation.

**Loss Returns:** In the context of discussion on losses it would be relevant to point out that the tax planner would do well to keep in mind the implications of the provisions of section 139(3) read with section 80.

If an assessee is to get the benefit of the determination of the loss and its carry forward under section 72(1) or 73(2) or 73A(2) or 74(1) or 74A(3), he should file a return voluntarily within the period specified in section 139(1).

However, filing of return within the period specified in section 139(1) is not necessary for carry forward of loss from house property under section 71B and unabsorbed depreciation.
14.4 GENERAL ANTI-AVOIDANCE RULES

There is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. The Base Erosion and Profits Shifting (BEPS) project of the Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

- Tax avoidance involves the legal exploitation of tax laws to one’s own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways.

The General Anti-Avoidance Rules (GAAR) provisions aim at combating ‘impermissible tax avoidance’. Many countries, like United Kingdom, China, South Africa, Australia, Canada, Brazil, have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

**The Indian GAAR**

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals. The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.
The Shome Committee Report explains the need for and rationale of GAAR as under:

(i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.

(ii) Transactions have to be real and are not to be looked at in isolation.

(iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.

(iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.

(v) The GAAR provisions codify this 'substance over form' basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y.2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.

Hitherto, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, inter alia, be considered specific examples of SAAR -

(i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible

(ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.

(iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions also made applicable to specified domestic transactions by the Finance Act, 2012.

(iv) Section 93 on avoidance of tax by transfer of income to nonresidents through transfer of assets, rights or interest.

(v) Section 94 on avoidance of tax by certain transactions in securities.

(vi) Section 94A on transactions with persons located in notified jurisdictions.

(vii) Section 2(22)(e) on deemed dividend.

(viii) Section 40(a)(i) and (ia) on disallowance of expenses for non-deduction of tax at source.

(ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.
(x) Explanations 1 to 13 to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.

Tax treaties also provide certain anti-avoidance rules for instance, Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

**Applicability of General Anti-Avoidance Rule [Section 95]**

(1) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.

(2) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

(3) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

(4) The term arrangement referred to in section 95 of the Act, has been defined in section 102 under clause (1) and means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding;

### Example 1

**Facts:**

M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2013-14 for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit in F.Y. 2020-21 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

**Interpretation:**

There is an arrangement of setting up of a unit in SEZ which results in a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

### Example 1A

**Facts:**

In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and
shows the same as manufactured in the tax exempt SEZ unit, while doing only the process of packaging there. Is GAAR applicable in such a case?

**Interpretation:**

This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance. Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

**Example 1B**

**Facts:**

In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

**Interpretation:**

As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through transfer pricing regulations that deny tax benefits. Hence, the Revenue would not invoke GAAR in such a case.

**Example 1C**

**Facts:**

In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

**Interpretation:**

The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section 10AA of the Act. Hence, the Revenue would not invoke GAAR in such a case.
Impermissible Avoidance Agreement [Section 96]

(1) An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:

(a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm’s length;
(b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
(c) lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or
(d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.

(2) The purpose test of obtaining tax benefit and tainted element test as under clauses (a) to (d) above are twin conditions that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term “tax benefit” has been defined in section 102 clause (10) as under -

(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or
(b) an increase in a refund of tax or other amount under this Act; or
(c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or
(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or
(e) a reduction in total income or
(f) an increase in loss,

in the relevant previous year or any other previous year.
(3) **The first tainted element** refers to non-arm’s length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm’s length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

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**Example -1**

**Facts:**

Y Tech Ltd. is a company resident of country C1. It enters into an agreement with Z Energy Ltd., an Indian company for setting up a power plant in India. It is a composite contract for an agreed price of US$ 100 million. The payment has been split in the following parts as per separate agreements

(i) US$ 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

(ii) US$ 70 million for offshore supplies of equipment etc (not taxable as no role is played by any PE in India. There are not subject to import duty)

(iii) US$ 20 million for local supplies and installation charges (taxable on net income basis)

It is found that the fair market value of offshore design is about USD 30 million; therefore it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case?

**Interpretation:**

The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied. (1) The main purpose of this arrangement is to obtain tax benefit; and (2) the transactions are not at arm’s length. Consequently, GAAR may be invoked and prices would be reallocated. However, determination of arm’s length price should be based on transfer pricing regulations under the Act.

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(4) **The second tainted element** refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.
Example-2

Facts:

Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement would be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.

(5) The third tainted element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance. [Dealt with in detail below]

(6) The fourth element refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.
Example-3

Facts:
An Indian company, A Ltd., makes an investment of ₹ 1 crore in shares of a listed company on 1st January, 2020. After a year, the prices go up and fair market value of shares becomes ₹ 11 crore. If A Ltd sells these shares, the long term capital gains of ₹ 10 crore would be exempt but it would be liable to tax under MAT @ the applicable rate.

A Ltd. forms a partnership firm with another person with nominal partnership. It transfers its shares in the firm at a cost price. No capital gain arises as per section 45 of the Act. After a year, the firm sells these shares and realises the gains of ₹ 10 crore which is exempt from taxation and no MAT is payable. Subsequently, the firm is dissolved and share of A Ltd in the partnership firm is transferred back along with profits, which is exempt from tax under the Act.

Can GAAR be invoked in this case?

Interpretation:
The only purpose of forming a partnership and transferring assets to such firm and selling the shares is to save tax arising out of MAT liability of A Ltd. Further, there is no commercial substance in the formation of the partnership as it does alter the economic position of A Ltd in terms of business risks or cash flow. Moreover, the entire exercise is carried out in an abnormal manner. Even holding of shares by the partnership firm for a year or more is no significant economic risk to the company. Hence, GAAR may be invoked and the partnership firm may be disregarded and capital gains may be subject to MAT in the hands of A Ltd.

Arrangement to lack commercial substance [Section 97]

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

(1) Under section 97, certain arrangements have been deemed to lack commercial substance as under—

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

(i) round trip financing;

(ii) an accommodating party;

(iii) elements that have effect of offsetting or cancelling each other; or

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or
(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter)

(2) Clause (a) is the codification of substance v. form doctrine. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the — substance of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

(3) Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter), without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Example-4

Facts:

Indco incorporates a Subco in a NTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $ 100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?
**Interpretation:**

The arrangement appears to be to avoid payment of tax on interest income by Indco in case the loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.

(4) Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase “accommodating party” has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

(5) Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(6) Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.

**Example -5**

**Facts:**

(i) X Ltd. is a banking institution in LTJ (Low Tax Jurisdiction);

(ii) There is a closely held company Subco in LTJ which is a wholly owned subsidiary
of another closely held Indian company Indco;

(iii) Subco has reserves and, if it provides a loan to Indco, it may be treated as deemed dividend under section 2(22)(e) of the Act.

(iv) Subco makes a term deposit with X bank Ltd. and X bank Ltd., on the basis of this security, provides a back to back loan to Indco.

Say, India-LTJ tax treaty provides that interest payment to a LTJ banking company is not taxable in India.

Can this be examined under GAAR?

**Interpretation:**

This is an arrangement whose main purpose is to bring money out of reserves in Subco to India without payment of due taxes. The tax benefit is saving of taxes on income to be received from Subco by way of dividend or deemed dividend. The arrangement disguises the source of funds by routing it through X bank Ltd.. X bank Ltd. may also be treated as an accommodating party. Hence, the arrangement shall be deemed to lack commercial substance.

Consequently, in the case of Indco, the loan amount would be treated as dividend income received from Subco to the extent reserves are available with Subco; and no expense by way of interest would be allowed.

In the case of X bank Ltd, exemption from tax on interest under the DTAA may not be allowed as X Ltd. is not a beneficial owner of the interest, provided the DTAA has anti-avoidance rule of beneficial ownership. If such anti-avoidance rule is absent in DTAA, then GAAR may be invoked to deny treaty benefit as arrangement will be perceived as an attempt to hide the source of funds of Subco.

(7) Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is
selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

**Example - 6**

**Facts:**

(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.
(ii) Z Ltd. is a company resident in India.
(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.
(iv) A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.
(v) The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.
(vi) A Ltd. is also designated as a permitted transferee of Y Ltd. Permitted transferee means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.
(vii) As per the joint venture agreement, 49% of X Ltd’s equity is allotted to A Ltd. and 51% is allotted to Z Ltd.
(viii) Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. Can GAAR be invoked to deny the treaty benefit?

**Interpretation:**

The arrangement of routing investment through country F1 results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is a LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit.
The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd. The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, unless it is a case where Circular 789 relating to Tax Residence Certificate in the case of Mauritius, or Limitation of Benefits clause in India-Singapore treaty is applicable, GAAR can be invoked.

Example -7

Facts:
A Ltd. is incorporated in country F1 as a wholly owned subsidiary of company Y Ltd. which is not a resident of F1 or of India. The India-F1 tax treaty provides for non-taxation of capital gains in India (the source country) and country F1 charges no capital gains tax in its domestic law. Some shares of X Ltd., an Indian company, are acquired by A Ltd in the year after date of coming into force of GAAR provisions. The entire funding for investment by A Ltd. in X Ltd. was done by Y Ltd. These shares are subsequently disposed of by A Ltd after 5 years. This results in capital gains which A Ltd. claims as not being taxable in India by virtue of the India-F1 tax treaty. A Ltd. has not made any other transaction during this period. Can GAAR be invoked?

Interpretation:
This is an arrangement which has been created with the main purpose of avoiding capital gains tax in India by routing investments through a favourable jurisdiction. There is neither a commercial purpose nor commercial substance in terms of business risks or cash flow to Y Ltd in setting up A Ltd. It should be immaterial here whether A Ltd has office, employee etc in country F1. Both the purpose test and tainted element tests are satisfied for the purpose of invoking GAAR.

In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;
(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

**Consequence of impermissible avoidance arrangement [Section 98]**

(1) If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital or revenue nature; or

(ii) any expenditure, deduction, relief or rebate;

(f) treating—

(i) the place of residence of any party to the arrangement; or

(ii) the situs of an asset or of a transaction,

at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(2) It has also been provided that –

(i) any equity may be treated as debt or vice versa;

(ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or

(iii) any expenditure, deduction, relief or rebate may be recharacterised.

**Treatment of connected persons and accommodating party [Section 99]**

(1) As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—
(i) the parties who are connected persons in relation to each other may be treated as one and the same person;

(ii) any accommodating party may be disregarded;

(iii) such accommodating party and any other party may be treated as one and the same person;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

(2) The term ‘connected person’ is defined in section 102 clause (4). Connected person means any person who is connected directly or indirectly to another person and includes -

<table>
<thead>
<tr>
<th>If Connected Person is an</th>
<th>A Company/Firm /AOP/BOI/HUF having substantial interest in the business of the person or any director/partner/member or any relative of such director/partner/member</th>
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Framing of guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA shall be applied in accordance with such guidelines and subject to such conditions as may be prescribed. The existing GAAR rules (2015) were amended by the CBDT on 22nd 2016. After the amendment, the applicable date of GAAR has been changed to April 1st 2017.

Some of the key recommendations that have found place in the rules are:
14.60 DIRECT TAX LAWS

(1) Threshold of ₹ 3 crores in respect of tax benefit in a relevant assessment year arising in aggregate to all parties to the arrangement.

(2) GAAR not to apply to Foreign Institutional Investors (“FII”) subject to satisfaction of certain conditions.

(3) As per the new GAAR notification by CBDT, the investments made before 1st April 2017 will be grandfathered.

(4) Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only. [Rule 10UA]

(5) As per Rule 10U(2), the provisions of GAAR can be invoked in respect of tax benefit obtained on or after 1.4.2017, from an arrangement, irrespective of the date on which such arrangements was entered into.


Clarifications on certain queries about implementation of GAAR [Circular No.7 of 2017 dated 27-1-2017]

The provisions of Chapter X-A of the Income Tax Act, 1961 relating to General Anti-Avoidance Rule will come into force from 1st April, 2017. Certain queries have been received by the Board about implementation of GAAR provisions. The Board constituted a Working Group in June, 2016 for this purpose. The Board has considered the comments of the Working Group and the following clarifications are issued:

Question no. 1: Will GAAR be invoked if SAAR applies?

Answer: It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.

Question no. 2: Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?

Answer: Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.

Question no. 3: Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?

Answer: GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.

Question no. 4: Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.
Answer: For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.

Question no. 5: Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?

Answer: Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income Tax Rules.

Question no. 6: The expression "investments" can cover investment in all forms of instruments - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, air craft leases) and loan arrangements, etc.

Answer: Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation. Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.

Question no. 7: Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?

Answer: No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.

Question no. 8: Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?

Answer: Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.

Question no. 9: Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a
Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.

**Answer:** GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.

**Question no. 10:** How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes and based on cogent evidence and not on the basis of interpretation difference?

**Answer:** The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.

**Question no. 11:** Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?

**Answer:** If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.

**Question no. 12:** A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4) of the IT Act.

**Answer:** Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.

**Question no. 13:** It may be ensured that in practice, the consequences of a transaction being treated as an ‘impermissible avoidance arrangement’ are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and fair manner. It should be clarified that if a particular consequence is applied in the hands of one of the participants, there would be corresponding adjustment in the hands of another participant.

**Answer:** Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.

**Question no. 14:** Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be
considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).

**Answer:** The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit’ enjoyed in Indian jurisdiction due to the ‘arrangement or part of the arrangement’. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs. 3 crores cannot be read in respect of a single taxpayer only.

**Question no. 15:** Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?

**Answer:** If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.

**Question no. 16:** No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.

**Answer:** Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.
Question 1
Distinguish between Tax planning and Tax Evasion

Answer
Tax planning is carried out within the framework of law by availing the deductions and exemptions permitted by law and thereby minimizing tax liability. Tax planning is an arrangement by which full advantage is taken of the concessions and benefits conferred by the statute, without violation of legal provisions. Tax evasion on the other hand is an attempt to reduce tax liability by dubious or artificial methods or downright fraud. It is illegal and denies the State its legitimate share of tax.

Question 2
Specify with reason, whether the following acts can be considered as (i) Tax planning; or (ii) Tax management; or (iii) Tax evasion.

(i) Mr. P deposits ₹ 1,00,000 in PPF account so as to reduce his total income from ₹ 3,40,000 to ₹ 2,40,000.

(ii) SQL Ltd. maintains register of tax deduction at source effected by it to enable timely compliance.

(iii) An individual tax payer making tax saver deposit of ₹ 1,00,000 in a nationalised bank.

(iv) A partnership firm obtaining declaration from lenders/depositors in Form No. 15G/15H and forwarding the same to income-tax authorities.

(v) A company installed an air-conditioner costing ₹ 75,000 at the residence of a director as per terms of his appointment but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation.

(vi) RR Ltd. issued a credit note for ₹ 80,000 as brokerage payable to Mr. Ramana who is the son of the managing director of the company. The purpose is to increase the total income of Mr. Ramana from ₹ 4,00,000 to ₹ 4,80,000 and reduce the income of RR Ltd. correspondingly.

(vii) A company remitted provident fund contribution of both its own contribution and employees’ contribution on monthly basis before due date.
### Answer

#### Tax Planning / Tax Management / Tax Evasion

<table>
<thead>
<tr>
<th></th>
<th>Answer</th>
<th>Reason</th>
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<tbody>
<tr>
<td>1</td>
<td>Tax planning</td>
<td>Depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.</td>
</tr>
<tr>
<td>2</td>
<td>Tax management</td>
<td>Maintaining register of payments subject to TDS helps in complying with the obligations under the Income-tax Act, 1961.</td>
</tr>
<tr>
<td>3</td>
<td>Tax planning</td>
<td>Making a tax saver deposit of ₹ 1,00,000 in a nationalized bank for claiming deduction under section 80C by an individual is a permitted tax planning measure under the provisions of income-tax law.</td>
</tr>
<tr>
<td>4</td>
<td>Tax management</td>
<td>Obtaining declaration from lenders/depositors in Form No. 15G/15H by a partnership firm and forwarding the same to Income-tax authorities is in the nature of compliance of statutory obligation under the Income-tax Act, 1961.</td>
</tr>
<tr>
<td>5</td>
<td>Tax evasion</td>
<td>An air conditioner fitted at the residence of a director as per the terms of his appointment would be a furniture qualifying for depreciation@10%, whereas an air conditioner fitted in a factory would be a plant qualifying for a higher depreciation@15%. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit and consequent tax liability. Treatment of air-conditioner fitted at the residence of a director as a plant fitted at the factory would tantamount to furnishing of false particulars with an attempt to evade tax.</td>
</tr>
<tr>
<td>6</td>
<td>Tax evasion</td>
<td>Issuance of a credit note for ₹ 80,000 by RR Ltd. as brokerage payable to Mr. Ramana, the son of the Managing Director, to increase his total income from ₹ 4 lakh to ₹ 4.80 lakh and to correspondingly reduce the company’s total income is a method of reducing the tax liability of the company by recording a fictitious transaction. The company is liable to tax at a flat rate of 30% whereas Mr. Ramana is liable to pay tax @ 5% above the basic exemption limit of ₹ 2,50,000, since his total income does not exceed ₹ 5,00,000. Further, Mr. Ramana would also eligible for rebate of ₹ 2,500 under section 87A if total income does not exceed ₹ 3,50,000. Reducing tax liability by recording a fictitious transaction would tantamount to tax evasion.</td>
</tr>
</tbody>
</table>
7. **Tax management**

Remitting of own contribution to provident fund and employees contribution to provident fund on a monthly basis before due date is proper compliance of the statutory obligations.

**Question 3**

*Examine the doctrine of form and substance in the context of tax planning.*

**Answer**

The following are certain principles enunciated by the Courts on the question as to whether it is the form or substance of a transaction, which will prevail in income-tax matters:

(i) **Form of transaction is to be considered in case of genuine transactions** - It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability whereas, if it is entered into in another form which is equally lawful, it may not. Therefore, in considering whether a transaction attracts tax or not, the form of the transaction put through is to be considered and not the substance. **However, this rule applies only to genuine transactions.** [CIT v. Motor and General Stores (P) Ltd. v. CIT (1967) 66 ITR 692(AP)]. Moreover, with General Anti Avoidance Rules coming into force with effect from A.Y.2017-18,

(ii) **True legal relation is the crucial element for taxability** - It is open for the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction. The taxing authority is entitled as well as bound to determine the true legal relation resulting from a transaction. The true legal relation arising from a transaction alone determines the taxability of a receipt arising from the transaction [CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC)].

(iii) **Substance (i.e. actual nature of expense) is relevant and not the form** –

(a) In the case of an expenditure, the mere fact that the payment is made under an agreement does not preclude the department from enquiring into the actual nature of the payment [Swadeshi Cotton Mills Co. Ltd. v. CIT (1967) 63 ITR 57(SC)].

(b) In order to determine whether a particular item of expenditure is of revenue or capital nature, the substance and not merely the form should be looked into. [Assam Bengal Cement Co. Ltd. v. CIT (1955) 27 ITR 34 (SC)].

**Question 4**

(a) The merger of a loss making company with a profit making one results in losses setting off profits, a lower net profit and lower tax liability for the merged company. Would the losses be disallowed by applying GAAR?

(b) In the above facts, let us presume, the profit making company merges with a loss making one. This results in losses setting off profits, a lower net profit and lower tax liability for both companies taken together. Can this be examined under GAAR?
Answer

(a) As regards setting off of losses, the provisions relating to merger and amalgamation already contain specific anti-avoidance safeguards. Therefore, GAAR would not be invoked when SAAR is applicable.

(b) In case of merger of a profit-making company with loss making company, there is no specific anti-avoidance safeguards. However, since such merger would be under the order of High Court, GAAR cannot be invoked as it falls in the negative list (as recommended) for invoking GAAR as mentioned in guidelines.

Question 5

A choice is made by a company by acquiring an asset on lease over outright purchase. The company claims deduction for lease rentals in case of acquisition through lease rather than depreciation as in the case of purchase of the asset. Would the lease rent payment, being higher than the depreciation, be disallowed as expense under GAAR?

Answer

GAAR provisions would not apply in this case as the taxpayer merely makes a selection out of the options available to him.

Question 6

Indco incorporates Subco in a NTJ with equity of US$100. Subco has no reserves; it gives a loan of US$100 to Indco at the rate of 10% p.a. which is utilized for business purposes. Indco claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?

Answer

The main purpose of the arrangement is to obtain interest deduction in the hands of Indco and thereby tax benefit. There is no commercial substance in establishing Subco since without it there is no effect on the business risk of Indco or any change in the cash flow (apart from the tax benefit). Moreover, it is a case of round tripping which means a case of deemed lack of commercial substance. Hence, it would be treated as an impermissible avoidance arrangement.

Consequently, in the case of Indco, interest payment would be disallowed by disregarding Subco. No corresponding relief would be allowed in the case of Subco by way of refund of taxes withheld, if any.

Question 7

(a) An Indian company, X Ltd., is a closely held company and it is a subsidiary of company Y Ltd. incorporated in country C1. X Ltd. was regularly distributing dividends but stopped distributing...
dividends from 1.4.2003, the date when dividend distribution tax was introduced in India. X Ltd. allowed its reserves to grow by not paying out dividends. As a result, no DDT was paid by the company. Subsequently, buyback of shares was offered by X Ltd. to its shareholder company Y Ltd.

Y Ltd. paid taxes on the capital gains arising on buyback of shares at the applicable rate. Can GAAR be invoked on the ground that there is a deferral of tax liability by X Ltd., the Indian company?

(b) In the above case (a), let us presume, there is a DTAA between India and Country C1 which provides that capital gains arising in India to a resident of country C1 shall not be taxed in India provided that the resident incurs $200,000 annually as operating expenditure. The shareholder Y Ltd. incurs an operating expenditure above that limit and is entitled to the treaty benefit. Y Ltd. therefore does not pay any tax on capital gains.

Can GAAR be invoked on the ground that accumulation of profits by company X Ltd. and subsequent buyback is an arrangement mainly to obtain tax benefit?

Answer

(a) Whether to pay dividend to its shareholder, or buy back its shares or issue bonus shares out of the accumulated reserves is a business choice of a company. Further, at what point of time a company makes such a choice is its strategic policy decision. Such decisions cannot be questioned under GAAR.

(b) Payment of dividend to its shareholder or buy back of its shares or issuing bonus shares out of the accumulated reserves is a business choice of a company, which a company is entitled to exercise at any point of time. It should be interpreted as incidental that the shareholder is entitled to a treaty benefit which exempts capital gains, but it is subject to SAAR (i.e. Limitation of Benefit clause). The decision of X Ltd. cannot be questioned under GAAR.

Question 8

A foreign bank J Ltd.’s branch in India arranges loan for an Indian borrower from another branch of J located in a third country. The loan is later assigned to J’s subsidiary in country F 3. The India-F3 Treaty provides no source based withholding tax on interest to a bank carrying out bona-fide business. This, therefore, results in no withholding tax on interest payment out of India.

Answer

The above arrangement of finalizing the loan from one country and assigning it to another country has been made mainly to avoid withholding tax provisions on the basis that there is no withholding provision on interest earned by F3 residents under the India-F3 treaty. There is a tainted element being abuse of the treaty and thus may be treated as an impermissible avoidance arrangement. The Revenue may invoke GAAR with regard to this arrangement.
Question 9

Company X borrowed money from Company Y and used it to buy shares in three 100% subsidiary companies of X. Though the fair market value per share was ₹100, X paid ₹600. The amount received by the said subsidiary companies was transferred back to another company connected to Y. The said shares were sold by X for ₹100/5 each and a short-term capital loss was claimed. This was set off against short-term capital gains from other sources. All the companies are Indian companies. Can GAAR be invoked?

Answer

By the above arrangement, the tax payer has obtained a tax benefit and created rights or obligations which are not ordinarily created between persons dealing at arm’s length. Since transactions of purchase and sale of shares of a closely held company at a price other than the fair market value are covered under section 56 of the Act, GAAR may not be invoked as section 56, being SAAR, is applicable. However, if SAAR is not applicable considering the limited scope of section 56 to the shares of closely held companies only, then GAAR may be invoked.

Question 10

M/s Global Architects Inc is a company incorporated in country F1. It is engaged in the business of providing architectural design services all over the world. It receives an offer from Lovely Resorts Pvt Ltd, an Indian company, for design and development of resorts all over India.

India-F1 tax treaty provides that architectural services are technical services and payment for the same to a company may be taxed in India. However, if such professional services are provided by a firm or individual, then payment for such services are taxable only if the firm has a fixed base in India or stay of partners/employees in India exceed 180 days.

M/s Global Architects Inc forms a partnership firm with a third party (director of the company) having only a nominal share in the F1. The firm enters into an agreement to carry out the services in India. The company seconded its trained manpower to the firm.

Thus, the partnership firm claimed the treaty benefit and no tax was paid in India. Can such an arrangement be examined under GAAR?

Answer

It is obvious that there was no commercial necessity to create a separate firm except to obtain the tax benefit. The firm was only on paper as the manpower was drawn from the company. The firm did not have any commercial substance. Moreover, it is a case of treaty abuse. Hence, GAAR may be invoked to disregard the firm and tax payment for architectural services as fee for technical services. However, the rate of tax on such payment shall be as applicable under the treaty, if more beneficial.
Question 11

An Indian holding company Holdco borrows ₹ 10 crore for acquisition of shares of Subco which then became subsidiary of Holdco. Holdco and Subco amalgamate so that the interest payable on the monies borrowed to acquire the shares can be deducted in computing the income from the business of the amalgamated company.

Answer

The borrowing by Holdco followed by the amalgamation by Subco is not abusive and GAAR would not apply in the case of merger which is carried out under the orders of High Court.