INTERNATIONAL FISCAL ASSOCIATION

INDIA BRANCH – WESTERN REGION CHAPTER

FORM AND SUBSTANCE IN TAX LAW –

FACTS AND DELIBERATION OF THE FOUR CASES DISCUSSED AT OSLO AND AN OVERVIEW FROM AN INDIAN PERSPECTIVE

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1. One of the two main subjects at the 56th IFA Congress in Oslo in August 2002 was "Form and Substance in Tax Law". A related subject, "The Interpretation of Tax Laws with special reference to Form and Substance" was dealt with at the IFA Congress in London as far back as 1965.

2. Reports from 27 countries on the issue of Form and Substance in Tax Laws were received. The report on India was submitted by Mr. S.R. Wadhwa, formerly Member of the Settlement Commission and Mr. P.K. Sahu, Advocate. They have written a very comprehensive and good report setting out the developments and present position of the case law in India on Form and Substance.

3. IFA had requested all the reporters to address certain specific issues and to prepare their reports on the basis of certain detailed guidelines. From the reports on these issues, we are able to compare the different treatment that countries have given in certain situations, and how general principles have been applied in practice.

4. A general report was compiled from these 27 reports and the general reports and these 27 reports are published in one volume called a Cahier. The reports have been quoted from or paraphrased in several places, in this Overview.

5. At Oslo, the sessions on Form and Substance centred on discussions of a U.K. case, a US case, a French case and a Japanese case. The development of the concept of Form and Substance and the trends visible were discussed. These four cases are set out in the material that has been distributed

6. Let us first take up the U.S. case, United Parcel Service of America v. Commissioner.

7. The facts were that a very large courier and parcel delivery Company covered the cost of lost or damaged packages upto $100 and offered customers the option of purchasing insurance against excess value for additional fee. This Excess Value Charge business

was very profitable to the Company. The Company decided to restructure the Excess Value Charge business and entered into a contract to assign Excess Value Charges and liabilities to an unrelated insurance Company. The parcel Company however continued to perform all customer services relating to selling insurance, administering claims etc. The Company also created a Bermuda Subsidiary and required the unrelated insurer to re-insure all of its exposure as a result of which the unrelated insurer would retain only a fixed fee. The actual liability for insurance fell upon the Bermuda Subsidiary. The Company then distributed the shares of the subsidiary to its own shareholders and valued the same at par without assigning any extra value on account of the benefits that the subsidiary would get from the reinsurance contract. The Company paid out all the excess value charges received and claimed a deduction. The Insurer in turn paid out to the Bermuda Company and claimed a deduction. The net income was thus no longer subject to US tax as Bermuda is a tax haven.

How would you decide this case and on what basis?

Do you feel that there is any avoidance or evasion in this?

Is it a device? Is there some kind of transfer pricing issue?

8. It was decided by the US tax court that the arrangement was a sham lacking in economic substance and a business purpose and thus no deduction for Excess Value Charges was allowed. The Court held that the arrangement lacked economic substance because UPS continued to perform all services and because the payments of Excess Value Charges far exceeded an arms length payment for the insurance provided by the insurer and in turn by the Bermuda Company and there was no effective financial risk to the Bermuda Company. The arrangement lacked business purpose because all that was accomplished was shifting of income from a tax paying US corporation to a foreign corporation not subject to US tax. Although the Internal Revenue Service argued that even if the arrangement was not a sham the price could be adjusted under section 482 of the Internal Revenue Code which permits adjustments for payments between related parties not made at arms length, the Court did not decide the transfer pricing issue.

9. The matter was taken in appeal and the Court of Appeals by a 2:1 vote held that the transaction had economic substance because the Bermuda Company undertook economic activity of real value notwithstanding the fact that it was overpaid for that activity and it had business purpose in the sense that the transaction was undertaken in the context of and related to a real ongoing business. The Court remanded the case to the tax court to resolve the section 482 transfer pricing issue.

10. The discussion at the IFA Congress at Oslo on this case was that the transaction clearly resulted in the shifting of substantial

income and warranted close scrutiny. The IRS should have argued that the transaction could be respected provided that the shares of the Bermuda Company which were distributed to the shareholders should have been properly valued taking into account the benefits which would be derived from the contract.

11. The IRS did attack the price paid for the insurance as being non-arms length. But this attack failed probably because UPS and the Bermuda Company did not directly transact with each other.

12. This case illustrates how the sham transaction doctrine is applied subjectively by judges to permit or deny tax planning schemes based on their view of the extent to which they are abusive. The majority opinion in the appeal court was that the transaction had business purpose and economic substance even though it was tax motivated because it was in the context of real business.

13. **U.K. case**:

Re-characterisation of terms and concepts and the use of Substance v. Form doctrines was the issue in the case of Mac Niven v. Westmoreland Investments Ltd. UK (2001 UKHL 6). In this case a pension fund which is a tax exempt body had a subsidiary which owed it substantial amounts of money including accrued but unpaid interest. The law was that interest would be allowed only if actually paid, similar, in some ways, to our section 43B. The holding Company gave a further loan to Westmoreland which then paid the interest to the holding Company. The question was whether Westmoreland **"paid"** interest? The tax court said yes, it had paid. The High Court said no, and the Court of Appeals and then the House of Lords said yes, but gave different reasons. The Court of Appeals held that this was not tax avoidance but if the parties got some benefits otherwise (as they did) it would be tax mitigation. The House of Lords said that the term 'paid' must be interpreted **juristically** and **not commercially**. Since the interest had been paid, a deduction would be allowed to Westmoreland. One of the commentators at Oslo however commented that if Lord Hoffman, who wrote the judgement, had gone home and asked Lady Hoffman whether she felt that an amount had been paid by the subsidiary, she would probably say no, as there would have been no reduction in the total debt burden of the subsidiary. The Court however preferred to interpret the word 'paid' in a juristic rather then a commercial sense and allowed the deduction.

14 **French case**:

The facts in the French case (CAA Lyon 26 Mai 1992 no 102 et 110, REGIE IMMOBILIERE DE VILLEUROANNE and Instruction 1.2.00 dated 8.3.2000) were that Company A which had a small capital, borrowed money on interest and acquired 90% of the shares of

Company B. In the next year B merged into A. The issue was whether the interest payable by the amalgamated company was allowable as a deduction. In a normal case of leveraged buy out, Company B would first pay its tax, then declare a dividend and the interest would be paid out of the dividend. By virtue of the merger the first step taxation was avoided.

15. The tax authorities contested it on the ground that Article 225-26 of the new French Commercial Code prohibits a company from providing loans or guarantees for the purchase of its own shares, similar to section 77 of our Companies Act, which applies to public companies, and that this two step transaction which was clearly pre-planned was for tax avoidance.

16. The French Court however allowed the deduction.

17. At Oslo, the discussions centred around three aspects:-

i) that even though the financing of the purchase of one's own shares may be illegal, this would not disentitle the assessee as there is no general principle that illegal acts should be ignored (on the contrary, illegal income is taxable - as in the Indian case, CWT v. S.C. Kothari 82 ITR 794).

ii) A successful challenge could have been based only on the grounds of "**Abnormal act of management**" or "**abuse of law**". This was not an act of management, but of the shareholders, as distinguished from management.

iii) It would be difficult to prove "abuse of law" in this case, as the entire series of actions, namely the first step of acquisition and the second step of merger have to be considered together, and the objectives were **economic, financial and fiscal gain, and not merely fiscal gain.**

18. In all these three cases, the legal form adopted by the assessees was upheld.

19. **Japanese case:**

In the Japanese case, however the result was different. Certain persons were encouraged to invest in the acquisition of films and back-to-back leasing arrangements though a complicated structure.

20. The prospectus itself was prepared and distributed by Merrill Lynch Capital Markets and was in English although the investors were Japanese. From this the Court inferred that the investors were not really interested in knowing their legal rights, but only the figures. It explicitly stated that there would be substantial tax benefit from the depreciation and the interest payments, even more than the investment itself.

21. **The Osaka District Court, and, in appeal, the Osaka High Court held that the Investing Company did not actually acquire any rights to**

the films, because it entered into back-to-back contracts, and the real object was to get profit and tax benefits and not to acquire ownership rights. The ownership right was thus simply a form, not substance. The deduction of depreciation was denied.

22. Even with such detailed discussion and study, it is impossible to predict or even to give a strong opinion on what the law is on a particular set of facts and circumstances and what the result of a case would be, because so much depends on the form of presentation and the substance of the arguments and the view of the judge.

23. But the most interesting part of the reports is the academic analysis that has been made of these decisions and the identification and labelling of techniques which have been used in these cases and the attempt to discern trends.

24. The trend of decisions in the UK was discussed at Oslo and is set out in the General Report and in the UK Report. Briefly it is this:

> 1936: Duke of Westiminister v. CIR (1936 AC 1) Respect for legal rights and benevolent neutrality to tax schemes (i.e. Form prevailed over Substance)
>
> 1981: W.T. Ramsay Ltd. v. IRC (1982 ac 300)
>
> Hostility to tax schemes (Substance prevailed over Form)
>
> 2001: MacNiven v. Westmoreland Investments Ltd. Juristie interpretation preferred to a commercial interpretation (Form prevailed over Substance).

25. A detailed exposition of the historical development in the UK of this principle is in the Judgement of Justice Chinappa Reddy in the case of Mc Dowell and Co. Ltd. v. CTO (1954 ITR 148 SC) who went on to quote Lord Atkin "when these ghosts of the past stand in the path of justice clanking their mediaeval chains, the proper course for the judge is to pass through them undeterred."

26. Justice Chinnappa Reddy went on to say that "in the very country of its birth, the principle of Westminster has been given a decent burial" and concluded.

> "It is neither fair nor desirable to expect the Legislature to intervene and take care of every device and scheme to avoid taxation. It is upto the Court to take stock to determine the nature of the new and sophisticated legal desires 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 Ramsay, Burma Oil and Dawson, to expose the devices for what they really are and to refuse to give judicial benediction."

27. I wonder what Justice Chinappa Reddy would say about the Westmoreland case. In fact the UK reporters comment"The House of Lords' decision early in 2001 in Mac Niven v. Westmoreland Investments Ltd. (2001 STC 237) makes the time of writing a particularly difficult one to describe the Ramsay doctrine. This decision has sought to rationalise the doctrine on a new basis, and in so doing it calls into question a number of aspects of the Ramsay formulation as previously developed by the Courts." (Footnote 2 on page 569 of the Cahier).

28. And elsewhere, "For an argument that the Ramsay principle is unconstitutional in any event, see Bartlett (1985) BTR 338. This article refers to Lord Radcliffe's view that judge-made law is constitutional, broadly, only if it is in an area in which Parliament is presently not active. It is interesting to note, then, that the schemes which have come before the courts in the Ramsay line of cases have generally been rendered ineffective by legislation shortly afterwards." (Note 31 on page 577 of the Cahier).

29. Now let us go back to the theory, with special reference to India.

30. If a case comes up wherein an Officer is not satisfied on what basis can he decide?

31. Is it on the basis of the **Constitution** of the country? In most countries the Constitution does not lay down any rules of interpretation or any guidelines relating to the approach to tax laws. However, "the Belgian Constitution considers taxation to be an infringement of individual freedom and the right to property, which implies that tax statutes should be interpreted and applied strictly; analogy is prohibited and in case of doubt the interpretation favourable to the tax payer will prevail. In total, this gives the impression of a very legalistic and strict regime. However, the Belgian Constitution does not prevent the legislature from using economic concepts in the tax law nor from enacting a general anti-abuse provision, which it did in 1993." (page 25 of Cahier).

32. In the US the Constitution requires that whatever is done has to be by due process of law and in India the general provision is that every act of the Government has to be in accordance with procedure established by law. These are however only general statements

33. We come then to the **statutes**. It appears that 15 out of the 27 countries have a GAAR (**General Anti Avoidance Rule**) in their statute. The earliest instances of such statutory provisions were of 1915 in Australia and 1919 in Germany.

34. India does not have a GAAR.

35. India and many other countries do have SAARs. (**Special Anti Avoidance Rules**). Some of these in India are:

Section 40A (2) - Payments to associated persons.

Section 43B-where economic substance prevails over accounting treatment.(It should be noted that section 115JB relating to Minimum Alternate Tax is the reverse of this, where form, i.e. the accounting treatment, prevails over economic substance).

Section 60 to 64 - Income of other persons included in the tax payers income.

Section 92 to 92E - Transfer pricing.

Section 93 _ Avoidance of tax by transfer of income to Non-Residents.

Section 94 - Bond Washing.

Chapter XXC- e.g. Development Agreements and takeover of companies.

TDS – in certain situations, eg. Section 194I which defines rent to include even payment for furniture, and read with Circulars (eg. Circular No.715 dated 8.8.1995, question No.23, which relates to the "content of the agreement" not "nomenclature"

Section 27 defines "Owner" as including an allottee of premises, a person in possession in part performance of a contract and a lessee for a period of more than one year. This is not necessarily an anti-avoidance rule, because for instance a lessee assigning his interest may lose the benefit of section 54 but for this provision, but it is a deeming provision or a legal fiction which fills in a different substance into the normal form.

36. **Judicial decisions.** – In several out of 27 countries judicial decisions are important and are the basis for deciding form v. substance issues. In the UK as stated earlier there has been a full circle from benevolent neutrality in the Westminster case to hostility in the Ramsay case to juristic interpretation and therefore neutrality or even encouragement, in the Westmoreland case. In India of course the cases most frequently referred to are McDowell and Company Ltd. v. CTO (154 ITR 148SC) and the case of CWT v. Arvind Narottam CIT 3 ITR 479 SC)

37. **The Theory**:

The concepts of Form and Substance.

"**Form**" or "**legal form**" refers to the concepts used in tax law.

"**Substance**" refers to the **economic content** of the transaction or legal relation, and is after referred to as "**economic substance**".

In many situations the form and substance co-incide. For instance when a person sells a property and the document prepared is a Sale Deed and the income or gain is offered for tax accordingly, there is no divergence between the legal form and substance, or no tension between the form and the substance.

For instance the sale of all the shares in a company may economically be more or less equivalent to selling all the assets of the company and the substance may be said to be a sale of assets whereas the form is that of sale of shares.

38. **Step Transaction**:

If two or more transactions are combined, these are referred to as **step transactions**. If such transactions bring the taxpayer back to approximately where he stated these are referred to as **circular step transactions** and their economic substance may be negligible or zero, for instance by a sale and immediate buy-back of the same object. "A owns shares in Company B. A sells it for a loss over the Stock Exchange and the next day his wholly owned Company buys the same number of shares in the same Company over the Stock Exchange. There is no agreement in advance concerning the buy-back of the shares". The Indian Reporter is of the opinion that this is a perfectly legitimate transaction. (page 53).

39. In other cases there is an economic substance, but a different one from that indicated by the legal form of the transactions, for instance, a sale through an intermediate subject. These are referred to as **Linear step transactions**. (page 24 of Cahier). "A sells shares to his wholly owned Company B Ltd. for their book value. A few days later B sells the shares to unrelated C at their 'considerably higher' market value. Can A be considered to have sold the shares directly to C at their market value?" The test is whether the inserted step has a commercial purpose and whether the transactions were pre-ordained. In the US such transactions may be challenged under the substance over form approach. This would require some interaction between two transactions but not necessarily in the form that the sale to C was contemplated before the sale to B Ltd., For corporate tax purposes a rule is suggested that at least 12 months must elapse for the first transaction to be **'old and cold'**. The transactions could also be challenged under the assigning of income doctrine.

In India a direct sale to C will be the result unless a taxpayer can show that the Income-tax avoidance is not the **sole purpose** of the transaction.

40. Several of the branch reports refer to the concept of **legal substance** or **legal reality**, which is to be distinguished from

economic substance, for instance whether a particular transaction should be charactrised as a sale or a lease.

41. The main function of the concept of legal substance is to point out that **sham or simulation transactions and wrong legal characterisations** by the tax payer will be disregarded for tax purposes.

42. **Approaches to law and facts in the law:**

"The application of tax law, like law generally, involves the assessment of facts and the interpretation of the law" (page 28 of Cahier) There are different approaches to this.

The UK Report refers to this as a three step process. First, one must establish the "**pure**" or "**primary facts**" (such as who said what to whom? Was a letter sent or not? **Secondary facts** or **legal facts** are explained as "the facts about the legal rights and obligations actually created between the parties, or the legal acts actually performed.

The second step is determining the **proper characterisation** of the legal facts.

The third step is the **interpretation** of the tax rule.

"In contrast, the Austrian report expressly states that there is only one step of assessment and characterisation of the facts of a case.".

43. **Sham/Simulation**:

"**Sham**" is a term used in common law contained such as the UK, USA, India etc. and "**simulation**" is used in several Civil law Codes, such as Germany, Austria etc.

a) The core of this concept is that the form which a legal relation is given does not cover the reality intended by the parties. This kind of situation often occurs in one of three ways:-

(i) there is no reality at all;

(ii) the simulated transaction covers another hidden transaction or relationship.

(iii) There is an intermediary, or "a man of straw".

The significance of the sham/simulation concept in tax law differs considerably depending whether a country in question has a tax avoidance rule or not. In Finland and Denmark there is a wide anti-avoidance rule and therefore the concept of sham/simulation is of little importance. In Canada before the introduction of the Tax Avoidance Rule, courts adopted a rather strict concept of "sham" requiring that the transaction be conducted with an **element of deceit**. In Mexico, the tax authorities cannot declare simulation by themselves but have to go to Public Prosecutor with a request to initiate a

process with the aim of declaring the transaction in question null and void as a simulation.

b) By its nature sham/simulation is often **difficult to prove**. In many countries, the **onus** of proving is on the tax authorities but the tax payers normally has a duty to provide information. Circumstantial and presumptive or indicative evidence is relevant. A court may decide that the facts and circumstances surrounding the transaction demonstrate that the real contract was different from the one they present.

In **Mexico** a court may declare that the operation carried out by the tax payers was not commercially logical and that the **legal form** given to the contract **did not coincide with its economic effect.**

c) The concept of sham/simulation - Generally countries have no specific tax law on sham/simulation concept but rely on the private law concept.

In order to explore the borderline between sham/simulation and tax avoidance, the Branch Reporters were asked to contemplate whether a simple dividend stripping case would possibly be considered sham/simulation (Page 31)

Many felt that the case may not be considered as sham/simulation but the issue of whether it can be regarded as tax avoidance was a separate one (sub-section 8.6 of the Cahier).

44. Can the tax payer invoke sham/simulation?

Himalaya Transport Syndicate Pvt.Ltd. v. CIT (140 ITR 1021 P&H) - A Company transferred one of its buses to its shareholder. However, the permit to run the bus could not be transferred. Nevertheless the bus was run for her account and she collected passenger tax that she paid to the Company which in turn paid over to the Government. The Company was taxed on the income but invoked substance over form and succeeded in court.

In Austria and Belgium the tax payer can also invoke this principle on the ground that taxation should be based on legal reality.

45. Transactions with wrong characterisation –

A transaction may be real between the parties which separates it from the typical sham/simulation cases. The question is whether the characterisation should be accepted for tax purposes. For instance, where the parties characterise a contract as a lease, an analysis of the legal rights and obligations in the contract may lead to the conclusion that a sale is a more correct characterisation. It appears that the tax authorities have the right and perhaps also an obligation to make their own characterisation and to use this as the basis for the tax assessment.

46. New Zealand - Matrimonial Case, but frequently cited in tax cases:

Mills v. Dowdall (1983) NZLR 154

Parents transferred shares and land to their married son on several occasions. If these were sales then the wife would have a claim on them. If these were gifts to him, the shares would be a separate property, which could not be claimed by the wife. Each transfer of shares was for monetary consideration followed by a programme of forgiveness of debt on several occasions. The court found that these were sales and not gifts.

It appears that the tax authorities in New Zealand do not succeed very often in arguing that the tax payer mis-characterised a transaction.

47. **Expectation that Rights and obligations will probably not be enforced -** In this group of cases the characterization made by the tax payer reflects the legal relations of the contract. However, there is reason to believe that conditions which are important in relation to the taxation issue will not be enforced in practice. The U.K. case of Duke of Westminster was a case in which there was a contract to provide an annuity, and it could reasonably be expected that the Duke's employees would not file a suit against him to recover wages. There is only a thin line between these and sham/simulation. However, a pivotal point is that the contract could be enforced legally if a party decides to do so.

In Luxembourg and Switzerland due to attachment of business taxation rules to accounting rules, such contracts would be accepted at face value in the first place but the tax benefit would be withdrawn when it becomes clear that the transaction was not carried through. The reverse situation is if a tax authority has not accepted the assertion of the tax payer but it turns out that the contract, contrary to the expectations, is enforced one may wonder what will happen. A correction would be carried out through an alteration of the taxation for the earlier year or through a deduction in the year of enforcement. (Page 36 -37)

48. **The role of the courts in Tax Avoidance Cases.**

For the courts, the main question is whether there is a possibility for them to develop anti-avoidance rules or doctrines.

In countries like Norway and the USA, courts have developed tax avoidance norms and this appears to have evolved as tax common law primarily from court decisions.

In the UK, on the other hand, it is commonly agreed that it is not open to the courts to supply a general anti-avoidance rule. Therefore the so-called new approach or the Ramsay line of cases from the beginning of the 1980s has not been explained as a court developing a tax avoidance norm. The traditional explanation is that

the Court has re-characterised the facts of the case ignoring certain steps or as a branch reporter put it "the doctrine says that in certain circumstances the court may in applying and not interpreting statutory provisions to transactions determine tax treatment as though the parties had implemented a transaction different to the one which they in fact implemented".

In the Westmoreland case the House of Lords emphasised that the new approach is based simply on the interpretation of the tax statute in question. This has led to renewed uncertainty as to the basic character of the Ramsay doctrine.

Canada Supreme Court-Singleton case - the tax paper withdrew partnership capital from the law firm of which he was a partner and bought a house. He replaced the partnership capital with borrowed money and claimed a deduction for the interest (which is not allowed on money borrowed to buy a home). The Supreme Court refused to re-characterise the transactions as a loan to buy a house. However, these results were reached without direct reference to constitutional rules (or to the subsequently enacted General Anti Avoidance Rule) (page 41 of Cahier)

In several countries courts do not have a power to develop an anti-avoidance rule. Canada seems to be an example and so do Belgium, New Zealand and Sweden.

49. **Scope of the Anti Avoidance Rules (Page 41).**

"Most of the Anti Avoidance Rules whether statute based or court based are comprehensive in the sense that they in principle cover all Income-tax questions or the larger part of them, e.g. Denmark and Norway have court based rules, and Sweden has a statute based rule. Other rules or doctrines have more limited scope. This is arguably the case for the UK Ramsay doctrine which only applies to certain circular and linear step transactions.

50. **Roots of Anti Avoidance Rules**

In India a development towards substance over form seems to have taken place. The UK Ramsay doctrine can be regarded as a step in the same direction.

Australia and Canada and New Zealand seem to reject any notion of economic substance over form unless stated in a tax statute.

51. **Structure of the Anti Avoidance Rules**

The focus is on some important structural elements of Anti Avoidance Rules.

Can there be more than one more General Anti Avoidance Rule?

Can Special Anti Avoidance Rules co-exist with General Anti Avoidance Rules, and what is the effect of this?

As discussed above, GAARs are often found in statutes. But they have developed also as non-statute-based doctrines. In the USA particularly a number of separate doctrines exist side by side. The **step transaction** doctrine, the **business purpose doctrine,** the **substance over form doctrine,** the **economic substance or economic sham doctrine**. The relation between them is not clear. They do overlap and it is common for the tax authorities to invoke as many of them as possible in a specific case in order for the courts to choose from them.

52. In other countries the Anti Avoidance Rule may encompass several of the aspects that have been developed as separate doctrines in US tax law.

53. France – In addition to the **abuse of law** provision in the statute book case law has developed a doctrine called the **theory of Abnormal Management acts** which allows reassessments based on the simple fact that a management decision was inconsistent with normal management behaviour.

54. **Separate conditions or all-round violation?** (page 44)

Are tax anti-avoidance rules structured as rules with fixed conditions which have to be fulfilled in order to strike down a transaction or do they rather point to important aspects which have to be taken into consideration in an all-round evaluation?. A middle position is also possible. Some conditions are mandatory while the rest are aspects in the all-round violation.

a) In the New Zealand statute for instance, an **arrangement** is required and its **purpose must be tax avoidance.**

b) "The **Swedish** law establishes three conditions. An **essential tax benefit** must arise for the tax payer. This advantage must be assumed to be the **main motive** for the transactions being undertaken and accepting the tax payer's contention must **violate the purpose of the legislation.**

c) The Belgian statutory rule authorises the tax authorities to re-characterise a transaction if they find it to be aimed at tax avoidance unless the tax payer proves a **legitimate economic need.**

55. However, some old statutory rules are more general in nature and do not give much guidance in determining which factors are decisive.

56. In countries with court based norms these are more blurred. One important question is whether a **subjective intent** to avoid tax is a condition for concluding the tax avoidance exists. (Page.45)

a) Most Anti Avoidance Rules seem to require some sort of subjective intent to avoid taxes or at least lack of business purpose of the transactions in question. But this is not a

condition, e.g. USA does not require a subjective intent but only that the objective conditions **indicate such an intent**. For instance the core of the **economic sham doctrine** is that the **economic substance** of a transaction is **insignificant relating to the tax benefits** being obtained.

b) In Germany the question of whether a subjective intent to avoid tax is required has been debated. The most recent court cases seem to keep the question open.

57. If a subjective intent is required, the next question is as to whether this must be the **sole intent** of the transaction and, if not, **how to balance** avoidance and non-avoidance intent attached to the same transaction.

58. France – The transaction must be carried out **solely for tax purposes.** In **Hungary** it must be established that the **sole purpose** is tax saving.

Sweden – Tax avoidance intent should be the **main** reason.

Austria - Pre-dominant motive.

Canada – primary purpose must be to save tax but the fact that a substantial tax benefit can be obtained is not necessarily sufficient to establish such a purpose.

59. **Australia** - FCT v. Spotless Services Ltd. & Anr. (1996) 34 AIR 183 . The test is whether tax benefit is the **dominant** purpose. This can be the case even if the transaction is commercially rational provided that the tax benefit is the "ruling, prevailing or most influential purpose".

60. This shows that the Anti Avoidance Rule can apply even in cases where the taxpayer has availed of an investment option clearly contemplated by the legislature. In this case the taxpayer had investment funds in the Cook Islands. Interest was lower than it would have been if the investment had been made in Australia but it was tax-free and the purpose of the transaction was obviously to take advantage of this. The Anti Avoidance rule was found to be applicable and it was assumed that the taxpayer alternatively would have invested the funds in Australia. The interest income was taxed.

61. Other aspects - Various doctrines (page 46)

a) "The cases most often covered by Anti Avoidance Rules are those of step transactions. This is one of the main US doctrines." "Except for India, the Ramsay approach in the UK does not seem to be valid in court practices in other commonwealth countries (but may be included in statute based rules)".

b) "The crucial question in step transaction rules and doctrines is the conditions for treating two or more transactions as integrated rather than separate. In the US various tests have been developed. The most far reaching of these is the so-called "**mutually inter-dependent test**" which asks whether the steps taken were so inter-dependent that the legal relation created by one transaction would have been fruitless without a completion of the series. The so-called end result focuses on the **end result test** intended by the parties, but because of the subjective element, it is difficult to apply".

c) UK - The approach is stricter. "First there must be a **pre-oriented series** of transactions which means that there must be no likelihood that the latest steps will not occur. Secondly the **inserted steps** must have **no commercial purpose** (as opposed to effect)" (page 47 of Cahier).

d) A German court said that -transactions which are **circumstantial, complex** and **artificial** are not accepted But the Branch Reporter feels that the court went too far in this case.

62. France - The doctrine of **Abnormal Management Acts** has developed. This is used with much more ease and success than the abuse of law procedure which requires the proof of an fraudulent intention. This covers certain step transaction cases.

63. **Australia - Choice doctrine**

a) Where the tax rules give the tax payer a choice between two or more options, the taxpayer's choice of legal form should be respected even in cases of artificial arrangements entered into with no other justification than saving taxes. The High Court later modified this position considerably as it decided that the choice doctrine should not cover transactions of an artificial or contrived nature. A residue of the choice doctrine is left, in that the avoidance rule will not apply where the taxpayer has made an election or exercised an option expressly provided for by the tax statute.(page 47)

b) Spain - While the right of the taxpayer to choose the legal form that leads to least tax is basic, the transaction chosen by the taxpayer will be respected only if it is produces **non-tax economic advantages.**(page 47-48)

64. USA - Another classic doctrine – **Business purpose doctrine.**

The focus is here on the **commercial** or other **non-commercial reason** to enter into the transactions. In both cases what it comes down to is the balancing of tax and non-tax reasons for entering into the transactions. A seemingly artificial transaction can be saved if it can he shown that tit was entered into for sound business reasons.

65. The relationship between **General** and **Special** Anti Avoidance Rules (Page 49)

a) Many countries have both general and special rules. In such cases should the special rule be considered as exhaustively regulating the tax avoidance issue in its area or can the general rule also be applicable? This has been debated in Germany. The Federal Tax court held that the general rule could not apply in such cases as a special rule would prevail. In December 2001 a new provision was added stating that the general rule was applicable unless the opposite was expressly stated. Common law countries seem to have taken another view.

b) UK - The existence of specific Anti Avoidance provisions in a particular area does not itself prevent the Ramsay principle from applying. (page 50).

66. General tax anti avoidance rules – How far do they reach (Page 50).

This is a core issue. Can the corporate veil be pierced for tax purposes. The Reporters from India, Sweden and the UK do not rule out the piercing of the corporate veil in tax cases.

67. A buys shares of Company B with the purpose of acquiring its assets through a liquidation. Can this be regarded as an acquisition of the assets themselves for tax purposes? Can sale of the shares of a Company under any circumstances be regarded as the sale of the assets of the Company? (Page 51).

68. Almost all the Reporters said no to both the above questions.

69. A dividend stripping case would not generally be treated as sham/simulation. In Germany a transaction would most probably be accepted particularly if these were carried out as market operations.

70. Is tax avoidance penalised?

In New Zealand penalty is 100%. In France 80%. Argentina between 50% and 100% in the US a person propagating of a scheme which amounts to a tax shelter (defined by the amount of deduction in proportion to the

investment) is obliged to register the shelter and provide certain informations about it and penalties are imposed if this is not done as required.

71. Many jurists are reluctant to accept that an assessee can invoke substance over forms, or not have decided on this issue. This may open up post-transactional tax-planning and the risk that the party to the transaction may be able to take inconsistent positions concerning the same transaction. It may be added that the taxpayer has the freedom of contract at his disposal which gives him the possibility to create the substance he wants and that therefore he needs no substance over form rule.

72. In the US there are two competing views. A strict view would only allow the taxpayer to invoke substance over form if he is able to do that in relation to his contract partner. A more liberal view gives him such a right if he can prove that his actions showed an honest and consistent respect for the substance of the transaction.

73. The Belgian Reporter focused on the importance of the way anti avoidance rules are framed. If the rule is designed as a tool in the hands of the tax authority as is the case with the Belgian statute based rule, then of course the taxpayer cannot invoke it. If on the other hand the rule in question defines the substance then the taxpayer may invoke it.

74. **Tax anti avoidance rules in a tax treaty context.** (page 60).

The question is whether a domestic tax anti avoidance rule can be applied where the transaction or legal relation in question is wholly or partly governed by foreign law e.g. where one step of a step transaction scheme takes place in another country. (page 63)

75. Some issues in Indian situations- An owner of property gave it on a 99 year lease and received the entire lease rent in advance and offered it for tax from year to year. She thereby had the use of the entire value and since her other income was low she paid very nominal tax over the years. The Income-tax department attempted to treat this as a sale.

76. In the early 1970s when the maximum rate of tax was 97.75% if a builder sold a flat for Rs.1,00,000/- and made a profit of Rs.10,000/- he was required to pay tax of Rs.9,775/- in that very year leaving only Rs.225/- in his hands for use in business i.e. assuming that he survived only on fresh air. A few builders however sold their flats, for say Rs.91,000/- and took Rs.9,000/- as a deposit repayable in instalments after 20 years and with a small rate of interest, say 1%. Could this be treated as a sale? There do not appear to be any reported cases on this point in India.

77. Example, transfer of shares in a Co-operative Society. Under private law i.e. non-tax law a member is only an allottee and can even lose his flat if he does not pay outgoings or violates the bye-laws in any way. However, under section 27 of the Income-tax Act he is treated as the owner and even for stamp duty purposes, for instance in the decision in the case of Hanuman Vitamin Foods Ltd., the Supreme Court confirming the Bombay High Court decision held that essentially there is transfer of immovable property and therefore that stamp duty was payable.

78. A person held the shares of a Company which held a property. He wished to sell the shares, and the buyer would gain control over the Company. The buyer would then not have to pay stamp duty and this was taken into account in arriving at the price. However, in order not to face any penal consequences, the parties filed Form 37I in respect of this transfer of shares and the Appropriate Authority issued a Certificate under section 269UL. This was a case where the assessee invoked form for one purpose and substance for another.

79. This also happens in the case of agreements which are classified as Business Service Agreements. On account of fear of the rent laws an owner of commercial premises may enter into business service agreements under which he provides some minor services such as the use of a telephone, a fax machine etc. In the event that the occupier seeks protection under the Rent Control Act, the owner may be able to contend that this was not a letting but that it amounted to an actual business service, under which he remained in possession and only gave the use of certain services and facilities. However, it may happen that the assessee for tax purposes claim a deduction for repairs, which now is at the rate of 30% of rental income. Alternatively it may happen that if the assessee claims depreciation and expenses or the set off of some carried forward business losses the Assessing Office may say that this is not a business services agreement but a pure letting, and disallow the expenses but thrust 30% deduction on the assessee. This stand may however become useful to the assessee in subsequent years.

80. I have not discussed the Indian decisions for several reasons - firstly, they were not discussed at the Oslo Congress and this is an Overview of what happened there, secondly because the decisions are analysed in the Report of Mr. Wadhwa and Mr. Sahu and thirdly because we all have some familiarity with the Indian cases. What I have done however is to attach a list of the cases referred to by Mr. Wadhwa and Mr. Sahu and also a separate list of some cases which have referred to that of McDowells.

81. Is an anti avoidance policy needed, and if so why? The concept of economic approach was introduced in German tax law in 1919. General tax anti avoidance rules are part of many modern Income-tax systems. A rule that legal substance will prevail over legal form is not sufficient (page 64). The challenge is to find the balance

between legal certainty on the one hand and equity and efficiency in taxation on the other.

LIST OF CASES REFERRED TO IN THE INDIA REPORT BY MR. S.R. WADHWA AND MR. P.K. SAHU

Submitted to the IFA Congress, 2002 at Oslo

1. CIT v. Kamaksha Narain Singh (1940) 8 ITR 563 (Pat).
2. Provident Fund Investment Co. Ltd. v. CIT (1953) 24 ITR 33 (Bom).
3. CIT v. Provident Fund Investment Co. Ltd. (1957) 32 ITR 190 (SC).
4. CIT v. Motors & General Stores (P) Ltd. (1967) 66 ITR 692 (SC).
5. Lakshmikanta Jha (Pandit) v. CIT (1970) 75 ITR 790 (SC).
6. CIT v. Gillanders Arbuthnot & Co. (1973) 87 ITR 407 (SC).
7. CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC).
8. IRC v. Duke of Westminster [1936] AC 1.
9. CIT v. A. Raman and Co. (1968) 67 ITR 11 (SC).
10. W.T. Ramsay Ltd. v. IRC [1981] 1 All ER 865.
11. IRC v. Burmah Oil Co. Ltd. [1982] STC 30.
12. Wood Polymer Ltd. In re/Bengal Hotels (P) Ltd., In re (1977) 47 Comp Cas 597 (Guj).
13. McDowell & Co. Ltd. v. CTO (1985) 154 ITR 148 (SC).
14. P.N.B. Finance Ltd. v. Shital Prasad Jain (1983) 54 Comp Cas 66 (Del).
15. Jyoti Ltd. v. Kanwaljit Kaur Bhasin (1987) 62 Comp Cas 626 (Del).
16. Trackways (P) Ltd. v. CST (1981) 47 STC 407 (MP).
17. Wood Polymer Ltd. In re/Bengal Hotels (P) Ltd., In re (1977) 109 ITR 177 (Guj).
18. Workmen of Associated Rubber Industry Ltd. v. Associated Rubber Industry Ltd. (1986) 157 ITR 77 (SC).
19. Shri Ambica Mills, In re (1986) 59 Comp Cas 368 (Guj).
20. State v. Renusagar Power Co. (1988) 4 SCC 591.
21. Sree Meenakshi Mills Ltd. v. CIT (1957) 31 ITR 28 (SC).
22. Ramalinga Choodambika Mills Ltd. v. CIT (1955) 28 ITR 952 (Mad).
23. East Khas Jharia Colliery Co. v. CIT (1943) 11 ITR 299 (Pat).
24. Himalaya Transport Syndicate (P) Ltd. v. CIT (1983) 140 ITR 1021 (P&H).
25. Madura Knitting Co. v. CIT (1956) 30 ITR 764 (Mad).
26. Kalwa Devadattam v. Union of India (1963) 49 ITR 165 (SC).

27. Metha (MM) v. CIT (1979) 117 ITR 362 (Cal).
28. CIT v. Jain (SP) (1973) 87 ITR 370 (SC).
29. Lachminarayan Madan Lal v. CIT (1972) 86 ITR 439 (SC).
30. CIT v. Durga Prasad More (1971) 82 ITR 540 (SC).
31. CIT v. Bhojraj Harichand (1946) 14 ITR 277 (Lah).
32. National Cement Mines Industries Ltd. v. CIT (1956) 29 ITR 629 (Cal).
33. CIT v. Stanton & Stavely (Overseas) Ltd. (1984) 146 ITR 405 (Cal).
34. CIT v. Puran Das Ranchoddas & Sons (1988) 169 ITR 480 (AP).
35. Union of India v. Gosalia Shipping (P) Ltd. (1978) 113 ITR 307 (SC).
36. CIT v. Panipat Woolen & General Mills Co. Ltd. (1976) 103 ITR 66 (SC)
37. Ramniklal Sunderlal v. CIT (1959) 36 ITR 464 (Bom).
38. CIT v. Panbari Tea Co. Ltd. (1965) 7 ITR 422 (SC).
39. Juggilal Kamlapat v. CIT (1969) 73 ITR 702 (SC).
40. Sundaram Finance Ltd. v. The State of Kerala (1966)17 STC 489 (SC).
41. Calcutta Chromotype Ltd. v. CCCE 1998 (99) ELT 202.
42. Neroth Oil Mills Co. Ltd. v. CIT (1987) 166 ITR 418 (Ker).
43. CIT v. Sakarlal Balabhai (1972) 86 ITR 2 (SC).
44. Sir Kikabhai Premchand v. CIT (1953) 24 ITR 506 (SC).
45. CIT v. Sir Homi Mehta's Executors (1955) 28 ITR 928 (Bom).
46. Rogers & Co. v. CIT (1958) 34 ITR 336 (Bom).
47. CIT v. Mugneeram Bangur & Co. (1963) 47 ITR 565 (Cal).
48. Furniss v. Dawson (1984) 1 All ER 530.
49. Chidambaram Chettiar v. CIT (1966) 60 ITR 28 (SC).
50. Smt. C. Kamala v. CIT (1978) 114 ITR 159 (Kar).
51. CIT v. Navdurga Transport Co. (1999) 235 ITR 158 (All).
52. CIT v. T.N. Arvinda Reddy (1999) 120 ITR 46 (SC).
53. R.B. Jodha Mal Kuthiala v. CIT (1971) 82 ITR 570 (SC).
54. Nawab Sir Mir Osman Ali Khan v. CWT (1986) 162 ITR 888 (SC).
55. CIT v. Podar Cements P. Ltd. (1997) 226 ITR 625 (SC).
56. CIT v. S. Ramal Ammal (1982) 135 ITR 292 (Mad).
57. CWT v. Arvind Narottam (1981) 73 ITR 479 (SC).