

Full length Research

Myth and reality of the imbricating concepts of tax avoidance and evasion

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The difference between tax avoidance and tax evasion is the thickness of a prison wall. “Human beings are greedy by nature and they want to extract the maximum out of what is potentially available to them, but there are ways of this extraction. Every way need not be wrong, though most of them are.” The difference between tax avoidance and tax evasion is that tax avoidance is legally permissible by law while tax evasion is not. Judicial pronouncements within India and outside India have always marked out this distinction between the two. The predominant feature in deciding the nature of any transaction is not the underlying motive but the legality of such transaction. In India till now, the difference between tax avoidance and evasion was very clear. In India, the law is settled that tax avoidance is legal and evasion is not. A taxpayer may create a device to arrange his commercial affairs to minimize his tax liability and its acceptance is based on operation of law. But the new proposed code has blurred distinction to a great extent. This Article tries to analyze this difference and the change in the scenario as would be brought by the proposed code.

Key words: Tax Avoidance, tax evasion, legality, human nature, tax avoidance v. tax evasion, tax planning, judicial interpretation, direct tax code-India (DTC-India), objectivity, general anti-avoidance rule (GAAR).

INTRODUCTION

The difference between tax avoidance and tax evasion is the thickness of a prison wall. “Human beings are greedy by nature and they want to extract the maximum out of what is potentially available to them, but there are ways of this extraction. Every way need not be wrong, though most of them are.” There are different ways by which a tax payer can escape his tax liability. But there is a thin line difference between escaping tax liability and overcoming tax burden. Everything can be done by both legal means and illegal means; consequently the outcome would also be accordingly legal and illegal respectively. One can escape from tax liability by illegal ways – this is understandable, but escaping or reducing tax liability and that too by legal manner – is it possible? Yes, it is very much possible to reduce burden of tax while remaining within the four corners of law. It is through the loopholes of which tax payers try to take the benefits for reducing their burden.

As a layman a doubt always crept into my mind that

how is it possible to take that advantage of loopholes and ambiguities in the law itself to do something which is not so very much aimed by any law or law maker! Every human being no matter how honest and how law abiding he is, he always try to take the maximum benefit out of the given situation and mould the rules and regulations which suits them the best and is maximum beneficial for them. This can be done easily by illegal means. Infact for taking any advantage illegally, there is actually no requirement of moulding any law or taking privilege of any provision- it simply requires to avoid any liability and escape the law. But once again the question arises that how to do it legally? It can be done either by way of interpretation or by the provisions available in law. But how is it possible? Why would the lawmakers themselves provide the ways or provisions to escape the tax liability? Isn't it against the very concept of tax statutes? Answer is not so difficult for those who have glanced taxing statutes. Generally Tax exemptions are provided for several situations. A tax payer can mould the situation to take the benefit of this exemptions or lesser liability. Sometimes even due to improper drafting and ambiguities in the provisions tax payer escapes his liability. But again this is expected from those sitting at

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such a high position to leave any scope of ambiguity and improper drafting. But alas! Absence of those with proper technical and professional knowledge from those positions is one of the drawbacks of our government structure. But the study does not concern with this paper. Talking about interpretation of taxing statutes, these are interpreted strictly like penal statutes. No liberal interpretation is permissible.

In India till now the difference between Tax avoidance and Evasion was very clear. In India, the law is settled that tax avoidance is legal and evasion is not. A taxpayer may create a device to arrange his commercial affairs to minimize his tax liability and its acceptance is based on operation of law. But the new proposed code has blurred distinction to a great extent. Let's try to analyze this difference and the change in the scenario as would be brought by the proposed code.

The concept of tax evasion and avoidance

Tax avoidance is the legal utilization of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. By contrast, tax evasion is the general term for efforts not to pay taxes by illegal means.

Meaning

Tax avoidance: It refers to those cases where the tax payer has apparently circumvented the law, without giving rise to a criminal offence by the use of a scheme, arrangement or device often of a complex nature whose sole purpose is to defer, reduce or completely avoid the tax payable under the law. In other words tax avoidance is the method of reducing incidence of tax by taking advantage of certain loopholes in tax laws (http://en.wikipedia.org/wiki/Tax_avoidance_and_tax_evasion 2010).

Tax evasion: It is an illegal practice where a person, organization or corporation intentionally avoids paying his/her/its true tax liability. Those caught evading taxes are generally subject to criminal charges and substantial penalties. Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means.

Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, profits or gains than actually earned; or overstating deductions) (<http://www.investopedia.com/terms/t/taxevasion.asp> 2010).

RESEARCH METHODOLOGY

Research will be more of descriptive and doctrinal research. The purpose behind the research is to bring the differences between the tax evasion and tax avoidance and analyzing them from the legal perspectives' especially in the light of coming DTC and judicial pronouncements. The data collection as such is divided into:

i) Primary data collection: Data collected through brainstorming, discussion, direct interviews and information gathering.

ii) Secondary data collection: Data collected through literature survey, journals, Internet search, company records/bulletin, CD-ROM search etc.

Primary reliance has been based on internet sources like Income Tax Authorities official website and the recent news articles available. An analysis of DTC 2011 has been done.

How dangerous is tax evasion?

"The avoidance of taxes is the only intellectual pursuit that carries any reward." Tax avoidance is legally permissible hence, it does not matter how it would effect because anything which law permits is in some or the way connected with the fulfilment of some legitimate purpose or aim, so the by-products of such a purpose is not so relevant. However, tax evasion can be proved to be really dangerous. Efforts should be even made to prevent the abuse or misuse of the legal provisions. In the case of *Mcdowell and co. ltd v. CTO*, evil consequences of tax avoidance are summarized as follows:

- 1) Substantial loss of much needed public revenue;
- 2) Serious disturbances caused to the economy;
- 3) Sense of injustice and inequality;
- 4) Ethics of transferring the burden of tax liability to the shoulders of the guideless good citizens from those of artful dodgers.

The judicial outlook towards tax evasion clearly explains how threat full tax evasion is for the economy. First, the Supreme Court decided that the government was wrong to freeze the bank accounts of five suspected terrorists. Then the high court ruled that thousands of Britons with offshore trusts must now pay backdated tax demands imposed under retrospective legislation, introduced in the 2008 finance Act. While no one should condone tax evasion, these trusts were legal forms of tax avoidance when they were set up. All things considered, it does make one wonder who the courts regard as the real



Figure 1. Tax planning.

threat to society. (<http://blogs.telegraph.co.uk/finance/ianmcowie/100003388/tax-avoidance-or-terrorism-which-is-the-biggest-threat/2010>).

Tax planning versus tax evasion and avoidance

Tax planning is not tax evasion!

“Whatever is valid in the eyes of law cannot become invalid merely because it also results in tax being saved!” Tax planning, tax efficiency and tax avoidance by companies is not equal to tax evasion. These are the different approaches to the same objective that is, tax reduction (Figure 1). However, they have different characteristics and tax planning is perfectly legal as the object of tax reduction is achieved by making use of the beneficial provisions in the tax laws. On the other hand, tax avoidance is also legal though technically satisfying the requirements of law. Tax evasion is the method of evading tax by dishonest means like suppression, conscious violation of rules, etc. the prime objectives of tax planning are: reduction of tax liability, minimisation of litigation, productive investment, healthy growth of economy and economic stability. There is a very thin line of demarcation between tax avoidance and tax evasion; though both result in avoidance of tax. The distinction between the two lies in the legality of a transaction. Deliberate attempt to subvert the law or manipulation of records to obtain tax relief is an illegal act and would be regarded as tax evasion and is impermissible.

On the contrary, tax avoidance involves arranging transactions within the permissible boundaries of law to secure a tax advantage and is generally accepted as legal. The courts have attempted to provide some

distinction between unacceptable tax evasion and acceptable tax avoidance, which is increasingly referred to as tax planning. However, there certainly exists a grey area between legitimate tax avoidance/ planning and illegal tax avoidance and the distinction has become increasingly blurred, in view of varying and often conflicting views of the courts. This leads to increase in uncertainty in the tax system, which is something businesses do not want (http://www.moneycontrol.com/news/management/tax-planning-is-not-tax-evasion_438940.html).

Birla controversy

This can be very well understood in the light of very recent controversy with respect to restructuring of Aditya Birla cement group resulting in some tax benefit to the group- It is a transaction that created the country's largest cement maker. In October last year, group company Grasim demerged its cement business into a wholly owned subsidiary Samruddhi cements, which was then to be merged with another group company Ultratech. This transfer of assets was undertaken to bring the group's cement operations under one legal entity and is structured as a court-approved scheme of arrangement by choosing the amalgamation route the transaction could avail of a capital gains tax exemption under section 47 of the Income Tax Act. An exemption that some experts thought would not pass muster with revenue, would the tax efficiency be interpreted as tax evasion? The issue can be settled by referring to the judicial pronouncements without much difficulty. Verdict by Apex court in A Raman and Co case supports the Birla's case. It says that “Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited.”

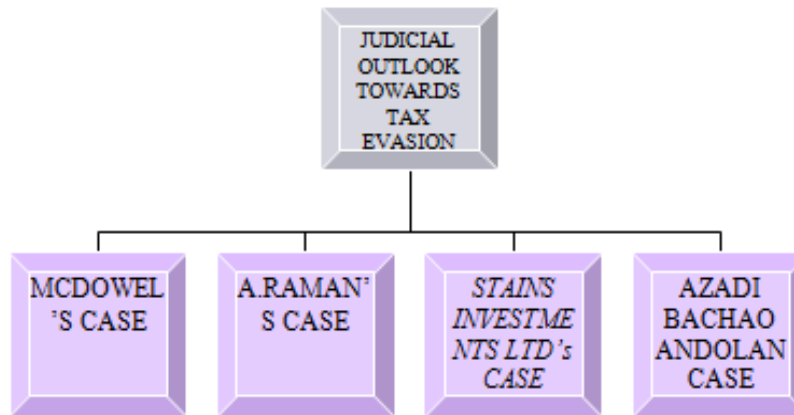


Figure 2. Judicial outlook- Indian scenario.

(http://www.moneycontrol.com/news/management/tax-planning-is-not-tax-evasion_438940.html)

Star controversy

Yet in another recent dispute of star entertainment channels the Authority for Advance Rulings (AAR) ruled that "It is within the legitimate freedom of the contracting parties to enter into a transaction, which has the effect of extending to the party the benefit of exemption under the taxation statute. The contracting party is not bound to enter into a transaction in such a way that it results in tax liability while foregoing the benefit of exemption under law." This ruling actually addresses that fear. This ruling analyzes the fact that tax evasion and tax planning is different. If there is a genuine business transaction and tax planning happens because there are ways to structure the transaction in tax laws and land up paying no tax, then one cannot say it is tax evasion. The ruling is a welcome development and will provide guidance to evaluate acceptable tax planning in domestic and international business restructuring. (http://www.moneycontrol.com/news/management/tax-planning-is-not-tax-evasion_438940.html)

Judicial interpretation

Outlook of judiciary –outside India

Verdicts have come from different courts in various jurisdictions distinguishing tax evasion from tax avoidance or laying down the nature of these. The crux of these decisions is that "the legal right of an individual to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted." Avoidance of tax is not tax evasion and, it carries no ignominy with it, anybody can so arrange his affairs so as to reduce the burden of tax to

minimum. This was held by the house of Lords in the Lord Tomlin TRC vs Duke of Westminster case. The house in that case stated that the citizen has the legal right to dispose of his capital and income so as to attract upon himself the least amount of tax. Yet in another case, the W. T. Ramsay vs Inland revenue commissioners case, the house laid the principle that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately. This case marked the significant departure of judiciary in England in their outlook towards tax avoidance schemes. The significance of Ramsay as a turning point in the interpretation of tax laws in England and the departure from the strings of Westminster were explained in Inland revenue commissioners vs Burmah Oil Co. Ltd.

Judicial outlook- Indian scenario

Talking about Indian scenario and outlook of Judiciary towards these transactions three important things observed are:

- 1) Influence of the decisions of House of Lords;
- 2) The major criteria in deciding the nature of any transaction or distinguishing is the legality and permissibility of that transaction; and
- 3) An attempt to overcome the abuse of Law by the tax payers.

Before the decision in Mcdowell's case, the scene was that anything which in some or the other way, by restructuring, manipulation or in any manner comes within the purview of legal framework are permissible (Figure 2). In the CIT vs. A. Raman and Co. case, the Supreme Court of India observed that avoidance of tax

liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented. However, the Supreme Court in *McDowell vs. CTO* took the view that the legal position in case of tax avoidance should be taken as altered in the light of the judgments given by the House of Lords. With this the outlook has been changed. Tax planning may be legitimate, provided it is within the framework of law, colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods.

As in all areas of law, the jurisprudence developed and, the courts permitted the scheme, if there was a strong commercial motivation behind a series of transactions and tax benefit was only incidental. This was the case in *Pigott vs Staines Investments Ltd* which involved a company securing a tax advantage from transferring profits within a group. The court decided that the method of transferring profits was normal and commercial and the fact that a tax advantage was obtained was purely incidental. The aforestated principles and decisions were discussed in great detail by the Supreme Court in the much celebrated *Azadi Bachao Aandolan* case rendered in 2002, wherein the court observed: "We are unable to agree with the submission that an act which is otherwise valid in law can be treated as *non est* merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents." The Supreme Court in this case also observed that the principle laid down in the *Westminster* case, namely, "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", is very much alive and kicking despite the hiccups of *McDowell*.

Legal framework under DTC: An attempt to bring tax evasion and avoidance under the purview of any taxing statute in India!

"The direct tax code (DTC), 2009, proposes to introduce general anti-avoidance rule (GAAR), which would erase the thin line between tax avoidance and tax evasion" Under the 1961 Act there are no direct and express provisions dealing with tax evasion and tax planning. Except some special provisions relating to avoidance of tax in International transactions under chapter x, section 92 and 93. To prevent aggressive tax avoidance, which the government believes undermines the integrity and equity of the system, general anti-avoidance Rule (GAAR) has been inserted vide Section 112 of the new direct taxes code (DTC). The GAAR has defined a transaction as an "arrangement" to mean any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not,

and includes any of the foregoing involving the alienation of property.

The expression "impermissible avoidance arrangement" has also been defined under Section 113 of the DTC to mean a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit and it, - creates rights, or obligations, which would not normally be created between persons dealing at arm's length; results, directly or indirectly, in the misuse, or abuse, of the provisions of the DTC; lacks commercial substance, in whole or in part; or is entered into, or carried out, by means, or in a manner, which would not normally be employed for bona fide purposes. These definitions of "arrangement" and "impermissible avoidance arrangement" are very wide and there is a genuine apprehension in the mind of the taxpayer that it might even encompass bona fide commercial transactions.

The direct tax code, 2009, proposes to introduce General anti-avoidance rule (GAAR), which would erase the thin line between tax avoidance and tax evasion. Section 112 of the code empowers revenue authorities to declare any arrangement as 'impermissible avoidance arrangement' if it results in certain tax benefits or it creates rights or obligations which would not normally be created between persons dealing at arm's length or it results in abuse of the provisions of the code, lacks commercial substance or lacks bonafide business purpose. It allows revenue authorities to disregard, combine or re-characterize any step in any such arrangement, or re-characterize equity into debt and vice versa.

Essential features

The code allows revenue authorities to label a transaction as lacking commercial substance, if it results in significant tax benefit to a contracting party without concomitant business risks or cash flows or if the legal substance is inconsistent with the legal form or it involves round trip financing.

The code also makes a presumption in favour of the revenue that an arrangement is entered into for the tax benefit alone, unless it is rebutted by the taxpayer. The burden of proof has been shifted on to the taxpayer to establish that obtaining a tax benefit was not the main purpose of the arrangement; else the arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit. The DTC proposes to prescribe penalties and prosecution for non compliance with the tax laws. Several provisions have been spelt out in the DTC which bestow tremendous powers on the revenue authorities to initiate due diligence exercise of the international transactions relating to tax offences and penalize the tax evaders as well (<http://www.thehindubusinessline.com/mentor/2009/10/19/stories/2009101950171100.htm>).

Concerns

General anti-avoidance rule (GAAR) has given too many wide discretionary powers in the hands of tax authorities. Commissioner has the power to decide as to which transaction is clothed with the motive of tax avoidance and what is the main purpose behind any transaction. The Commissioner has also the powers to disregard, re-characterise, combine transaction, etc. It not only apprehends the misuse or abuse of powers, as it is well settled that "an absolute power corrupts absolutely" but it also raise the concern as to the certainty in the tax system. Conferring so much power on the commissioner increases the level of subjectivity.

Further, the outline and the wording of GAAR induces an element of subjectivity due to the fact there is a possibility of the same being subject to different interpretation by various revenue officers, tax professionals and taxpayers. Therefore, instead of imparting certainty, which is one of the stated purposes behind DTC, more uncertainty would be introduced into the tax system, which will lead to further litigation. Unlike other jurisdictions, the DTC does not provide for any separate appeal mechanism in cases after the notice has been served to the tax payers for the invocation of GAAR. Absence of such an important provision increases the concern for more and more litigations and hardships for tax payers.

Besides that, the legislation has been over-prescriptive as to how transactions are to be re-characterised by GAAR. It has gone beyond principles laid down in Ramsay case. It even includes the incidental tax benefits. This would in a way increase the hardship of the tax payers and would interfere with the functioning of bonafide transactions. One of the major concern with the DTC, not only specific to the GAAR but in general, is the structuring and contours of this code. Existing tax code is complicated and this one has even defeated the existing one in terms of complications of the language used and the structuring of the provision. But again it would be wrong to expect a tax code without any uncomplicated approach!

Way forward

Some objectivity should be induced in the entire GAAR mechanism. Wide discretion given to the commissioner should be either curtailed down or proper checks should be imposed. This can be done by creating some supervising authority or better a proper appeal mechanism should be created. Advance ruling mechanism can act as a curb on the unbridled powers given to the commissioner to invoke GAAR. Creating a separate authority for appeal may invite the criticism of increasing the litigation and delaying the transactions of tax payers, but in the long run the advantages of this would override the anticipated evils. Not only it would

induce certainty in the system but would act as a check on the powers of authorities and make them accountable. The backlog of cases must be cleared to gear up for the new bout of litigation that may arise post-implementation of GAAR. To bring objectivity and certainty proper criteria for deciding the nature of any transaction, without conferring much discretion on the commissioner in this regard should be laid down. Tax payers need not be made to wait till the completion of due diligence by the concerned authorities/officers to understand the nature of their transaction as per DTC. Unless it is implemented judiciously along with a fast track 'alternative dispute resolution' mechanism, the new regime will elevate India's position on the taxpayers' hardship index.

As seen even under the existing Act the judicial pronouncements are being influenced by the situations and pronouncements in other jurisdictions. It would be beneficial to study the experiences of other jurisdictions where the GAAR has been introduced, its effectiveness in curbing tax evasion and its impact on investment climate. Instead of experimenting the new system directly it can be adopted through a well experienced system with the required changes as per the local requirements and conditions. It should be understood that GAAR should not go against the interest of bonafide tax payers and commercial transactions. If the general anti-avoidance provisions are invoked in casual manner they would cause tremendous inconvenience and hardship to genuine and bona fide taxpayers, and undermine the confidence, faith and trust of the taxpayer in the tax administration. Restrictions should be imposed on its invocation by laying down the grounds and criteria exhaustively as far as possible. The entire structuring of the code, if not possible to be simplified, should be at least made less complicated and understandable by the layman. Although, it would not be so wise to make a fiscal law in easy and common language, but it should not be overcomplicated and technical.

Conclusion

The difference between tax avoidance and tax evasion is that tax avoidance is legally permissible by law while tax evasion is not. Judicial pronouncements within India and outside India have always marked out this distinction between the two. The predominant feature in deciding the nature of any transaction is not the underlying motive but the legality of such transaction. However, this position is now going to be changed with DTC coming into force in coming years where the distinction between tax avoidance and evasion has been blurred to a great extent in order to restrict not only tax evasions but also tax avoidance. This is correct but only to the extent that it should not make the restriction and its scope so wide so as to include tax planning also within it, which otherwise is always should be encouraged. Further, there are certain concerns with the DTC and GAAR, which should

be overcome by the possible ways mentioned.

LIST OF CASES

Tomlin TRC vs Duke of Westminster, W. T. Ramsay vs Inland Revenue Commissioners, Inland Revenue Commissioners vs Burmah Oil Co. Ltd., CIT vs. A. Raman and Co, McDowell vs. CTO, Pigott vs Staines Investments Ltd, Azadi Bachao Aandolan case.

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