TAXATION OF COMPANIES

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CERTIFICATE

This is to certify that the research work entitled **"Taxation of Companies"** is the work done by **Akshay Maheshwari** under my guidance and supervision for the partial fulfillment of the requirement of B.B.A., LL.B. (Hons) degree at College of Legal Studies, University of Petroleum and Energy Studies, Dehradun.

Signature & Name of Supervisor

Designation

Date

DECLARATION

I declare that the dissertation titled **"Taxation of Compnaies"** is the outcome of my own work conducted under the supervision of **Mr. Sujith Surendaran**, at College of Legal Studies, University of Petroleum and Energy Studies, Dehradun.

I declare that the dissertation comprises only of my original work and due acknowledgement has been made in the text to all other material used.

Signature & Name of Student

Date

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ABBREVATION

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A.Y	Assessment Year
Cl.	Clause
DTAA	Double Taxation Avoidance Agreement
Sec	Section
ITA	Income Tax Act.,1961
CIT	Commissioner of Income Tax
CBDT	Central Board of Direct Taxes
ITAT	Income Tax Appellate Tribunal
P. Y.	Previous Year
MAT	Minimum Alternate Tax
STT	Securities Transaction Tax
DDT	Dividend Distribution TAx
SC	Supreme Curt
TDS	Tax Deduct at Source
w.e.f	With effect from
DTC	Direct Tax Code
SHE	Secondary and Higher Education
Pvt.	Private
Ltd	Limited
CA	Court of Appeal
HL	House of Lords
VIH	Vodafone International Holdings BV
FY	Financial Year
HC	High Court

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Chapter 1. Introduction/Background

The ancient Indian Vedic texts talk about the right of the king to raise revenue by taxation. The great Indian scholar Kautilya's '*Arth Sashtra*' has a Chapter of "*Taxation*". Manu, also an ancient Indian scholar in fact describes that that the king should realize taxes, "*little by little, as a leech, calf or bee, sucks blood, milk or honey*" thereby emphasizing the need to extract only what can be spared. As we all are aware that taxation as a revenue raising measure was not regionalized and has been adopted in the Anglo Saxon civilizations as well as European countries. But while there might be essential differences in the application there is little doubt that taxation is a common link for all mankind!

The history of Indian Taxation starts with the first Income Tax Law introduced in 1860 consequent on the financial difficulties arising from the Mutiny of 1857 which came to be known as the first struggle for independence

The tax was in force for a period of 5 years. It lapsed, but was revived in the form of a License Tax on Trades and professions. Later In 1868 a new tax known as "Certificate tax", not materially different from the "License Tax" was introduced which later came to include agricultural income as well.

With the improvement of financial position, 1873 witnessed the abolition of Income tax. This was not to last for long. The Great Famine 1876 to 1878 brought in the revival of Direct Taxation. This had the character of License Tax on trader and a cess on land. The tax was based on local condition which stressed the fact that the power to tax should be based on the ability to bear the burden and was enforced through local Acts.

In time a major improvement was that instead of specifying the rates of taxation in the Schedules to the Act it left the rates to be determined by the Annual Finance Act to give taxation structure greater flexibility and economic relevance. This feature has survived till today.

The period subsequent to 1939 witnessed the Second World War which necessitated raising higher revenues on the hand and a closer monitoring on large incomes which were made by certain assesses because of the war conditions.

1.1 The Early Beginnings

The law commission took a time span of two years to make a thoughtful and comprehensive Income Tax Act in the year 1958. Two areas which concerned the Government were (i) rationalization of the Law to prevent inconvenience to assessees and (ii) prevention of evasion of income tax. Direct Tax Enquiry Committee, popularly known as Thyagi Committee considered both the angles and submitted a detailed report in 1959 resulting in the Income Tax Act of 1961 which holds the field today, though substantially changed by frequent amendments from 1961 till now. Some of the Committees which deserve mention in the shaping of the Indian Tax Law in India perhaps are (i) Boothalingam Committee Report, (ii) Vanchoo Committee Report, (iii) Raja Chelliah Committee Report, among others.

In the annual Indian Budget for the year 1976, the Indian Finance Minister declared in the Budget Speech in Parliament that -

1. Realistic rates of taxation are preferable to confiscatory rates;
2. Social justice cannot be achieved in a poor country like India without economic growth and accent of tax should be on economic growth with social justice.

This paved way for a new era. The urge for an anchored tax regime was visible when the long term fiscal policy was declared in 1986. In the last decade taxation policy has witnessed sweep change starting with reduction of tax rates, repeal uneconomic tax law and streamlining the system. The earlier concept of integrated system of tax laws propounded by Prof. Kaldor which provided for a tax when you earn income, a tax when you owned wealth, a tax when you gifted a property, and tax when you die leaving property, with the result that at the end of the day, you will be surrounded by taxes, is no longer the norm today. The scheme has endured to become better.

The accentuation is now on compliance by the tax payer and reduction in discretion by the administration to a bare minimum. To let the system be upbeat, cooperation and compliance by the tax payers is a desideratum.

1.2 Objectives of Indian Taxation Law

To understand the objectives of taxation law it is necessary to deliberate upon the basic cannons of taxation as were given by Adam Smith. They are inter alia: Representation, Redistribution, Repricing and Revenue. The revenue raised by taxation is used for development of societal infrastructure, and for the functioning of government functionaries like justice dispensation, law and order. This is the utmost significant purpose. The function of redistribution talks about social equality where the wealth is transferred from the rich to the poor, the extent of which remains contentious in majority of democracies. The reprising function is to curb negative externalities such as use of alcohol, levying tax on pollution in form of carbon tax. The fourth function is A fourth, consequential effect of taxation in its historical setting has been representation. The American revolutionary slogan representation which can be summed up by the following phrase *"no taxation without representation*". It acts as a trade-off between tax and accountability. Various researches have revealed that there exists a large difference in accountability and governance generated by direct taxes and indirect taxes. The optimum understanding of these four R's considerably adds to the entire process. As was evident in a speech made by Sir Lesmoney of U.K. before the Royal Commission of Income Tax that taxation was the best expenditure he made such eminent declarations regarding the nature of taxation can be achieved only by stability in tax rates rationalization of tax structure, easy procedures, simple laws and a practical and humanitarian approach of the tax administration.

1.3 The Complications of Taxation Law

Taxation is a fascinating branch of law, though highly complex and complicated to comprehend. Its practice demands an adequate knowledge of accountancy and economics besides a fair knowledge of various commercial laws, personal laws, and laws relating to property as also civil criminal laws. The status imposing direct taxes on income or wealth are intricate, cast in language which is difficult to comprehend without concentrated effort.

Moreover some of the sections of the Income Tax Act run into pages, comprised of sub sections, sub clauses, provisos and explanations not forgetting the amendments. "*To the original Act have been made almost 3500 amendments till date.*" For a common man it is quite difficult to appreciate frequent changes brought about in the Act. It is a tragedy that millions of man-hours of tax gatherers, tax payers and tax advisors are squandered away in grapping with the torrential spirit of such amendments. There is an urgent need to appreciate that fiscal policy must attempt at simplification of direct tax laws. The ambiguity in the enactment of tax laws, therefore, needs to be avoided to reduce the zone of uncertainty in tax administration as also to ensure uniform application of laws, which in the ultimate analysis, lead to reduction in litigation. Increased litigation because of ambiguity of legislation is counter-productive and fails to achieve the object of the legislation.

1.4 Income and Taxation - Global Interpretations

While we are talking about the issues directly concerning the common man it would be apt to quote LORD MACMAGHTAN that "Income tax, if I may pardoned for saying so, is a tax on income".

In a federation like ours, if it were not tax on income, it may not be within the taxing powers of the Parliament adding a new dimension to the concept. However, in the Indian Constitution Entry No. 47 in list I of the Schedule VII gives wide a power to impose tax on items which are really not income. That was how Wealth Tax on agriculture lands was upheld in *Union of India V. Harbhajan Sigh Dhillon*[1] as reported at p.582 of 83 ITR by the Supreme Court of India.

The theory of 'real income' based upon the fundamental concepts has come to the help of the tax payer where the tax payer is unable to find in the maze of tax laws any other

[1] (1972) 83 ITR 582 (SC)

shelter, which spells out exemption from liability or any deduction. It is true that this concept cannot come to the aid of the tax payers merely because he claims something as not his income. Also when the Act deems a certain items as income the theory of real income will be of no avail.

The taxpayer as well as the tax gatherer must be not only diligent, but also must exercise abundant care and caution in ascertaining what the real income is that is eligible to tax and what would be the tax that becomes payable on the real income. Therefore, it is not the case that every income of the taxpayer is liable to tax in as much as, "it is not the case that the tax collected by the Government is entirely in respect of the income that is liable to tax. There may be certain deeming provisions that would creep in to make certain income though apparently on the face of its would not be income in the hands of tax payer but becomes so far that purpose of tax as a consequence of such deeming provisions, provides by the Act, as for example the provisions of Section 69 *etc.*, that it is to be taxed. Thus, the obvious statement of LORD MACMAGHTAN, as mentioned above is not without significance since, any amount of tax in excess of tax due form the taxpayer can be insisted only on the ground that income tax is a tax on income and nothing more or nothing less.

Historically tax policies have been developed primarily to address domestic, economic and social concerns. The forms and levels of taxation were established on the basis of desired level of publicly provided goods. Regard is also taken to the allocation, stabilizing and redistribute aims though appropriate for a country. The decision to have a high rate of tax and high level of Government spending or low taxes and limited public outlays, the mix of direct and indirect taxes and the use of tax incentives were all the matters which were decided primarily on the basis of domestic concerns and principally domestic tax systems. The accelerating process of globalization trade and Investment has fundamentally changed the relationship among domestic tax system. Globalization has:

1. Driving force behind tax reforms focused on broadening base and rate reductions thereby minimizing tax induced distortions.
2. Encouraged countries to assess continually tax systems and public expenditure with a view to making adjustments when appropriate to improve the fiscal climate investment.
3. Promoted the development of capital and financial markets.
4. Encouraged countries to reduce tax barriers to capital flows and the modernize their tax systems to reflect those developments.

1.5 Taxation in the New Millennium

The new millennium has witnessed changes all around. The State as a custodian of the common good has pledge itself to economic growth, social development, environmental protection and simultaneously secure for India a place in the Global map. The old concept of taxation as a tool to raise revenues is no longer extent. Taxing enactment can be the means to secure economic growth by social justice. The Income Tax Act contains provisions for economic growth by providing incentives to setting up industries in backward areas, incentives for exports incentives for undertakings set up in Export Promote Zones and 100% export oriented units with a view to encourage industrialization of the country, exemptions in respect of royalties for foreign enterprises, foreign remuneration to academicians, professional income from foreign sources and remuneration for services rendered outside India.

In order to encourage Information Technology and Computer related activities, deductions and allowances are provided to such businesses. With a view to secure infrastructure development, which improves the lot of the common men, Section 80 HHE and 80HHF provide for concessions in respect of infrastructure development. Concessions are given to Senior Citizens and women, rebates to encourage savings and investments and to promote thrift. The Income Tax Act recognizes that development society cannot be the sole responsibility of the State and Non-Governmental organizations contribute substantially to social development. In order to encourage such non-governmental organizations to work in conjunction with the Government to achieve the goal of social, educational and cultural development tax concessions are allowed to Charitable Trusts which contribute substantially to developmental activities.

Environmental protection has been a major area which causes considerable concern. In order to secure these ends provisions has been made in the Income Tax Act to provide incentive for shifting businesses from urban to non-urban areas with a view to reduce imbalances in the ecology. This provision has also a social objective namely, promoting jobs in non-urban areas and to prevent exodus of people from non-urban to urban areas.

Realizing the importance of Taxation, the Government of India constituted Tax Reforms Committee with Dr. Rajah J. Chealliah as its Chairman to review the existing structure of Direct and Indirect Taxes. The Committee under the able leadership of Dr. Chelliah has recommended many far reaching useful changes like lowering of fax for domestic and foreign companies. Taxation of agricultural income of non-formers, gradual transformation of the present Excise Tax system to a genuine value added Tax (VAT) at the stage of manufacture, extension of Modavat to more items, reformation of the existing duty regime for Textile Sector, abolition of Interest Tax and retention of the general rate of depreciation on Plant and Machinery at 25%. The Committee has made various other recommendations and structural reforms in Taxation with a view to make this country progressive.

These apart, tumultuous changes are taking place in the thinking process of various Governments and people the world over. At this stage the pertinent question for Indian leaders would be, how far the free markets and the opening up of the economy can improve the resource availability at competitive costs and increase the efficiency of resource utilization. Fiscal and monetary policies concern the very basic frame work of the economy. A frame work inevitably means some constraint. Nevertheless, all constraints are not always inevitable. The other opinion is that of Haliburton, who said years ago to that, "death and taxes are inevitable. Perhaps, the truth is what has been attributed to J.B. Colbert who seems to have said that the art of taxation consists in "so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing".

Chapter 2. Companies under Income Tax Act

2.1 Company: Section 2(17) of the Income Tax Act, 1961 defines the expression "company "and means:

(*i*) any Indian company, or

(*ii*) any body corporate incorporated by or under the laws of a country outside India, or

(*iii*) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or

(*iv*) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company :

The original definition, which was replaced by the present one in 1971, is the same as in 1922 Act, except that it includes an 'Indian Company' which is defined by Clause 26 in wider terms than the 1922 Act. Under general law a company is a juristic person and is distinct from the shareholders; it is the company which owns the property and not the shareholder.[2] For the purpose of the Income Tax Act, 'company, has a much wider connotation than the words bear under the Indian Company Law and includes an unincorporated institution, association or body, whether Indian or non-Indian, which is declared by the Board to be a company. In such cases, what is not legal entity would yet be assessable as a company. Further from the A.Y. 1971-1972 onwards the present has

[2] *Bacha Guzdar v. CIT* 27 ITR 1 (SC); *APSRTC v. ITO* 52 ITR 524,532 (SC)

brought within its outreach every company incorporated in a foreign country, irrespective of any other consideration.

A company which is registered under the Indian Company law would fall within cl (i) of the definition, and must be assessed as a company, even though its certificate of incorporation might have been improperly obtained[3]. A company registered under Section 25 of the erstwhile Companies Act, without commercial or profit-making motive must nevertheless be assessed as a company under this Act.[4] A company in liquidation is a 'company' within the meaning of this sub-section, and the department is entitled without leave of the winding up court to call upon liquidator of the company, as its principal officer, to make a return. Like penalty proceeding can be commenced against a company in liquidation for default committed prior to liquidation.

Limited companies who carry on business are separate taxable persons, and the profits and gains of their several business are separate profits and gains for the purpose of Act. This is none the less true if one of the companies is a parent company and the other a subsidiary of which shares are held by the former company.[5]

2.1.1 One person company: A one-man company is a distinct assessable and legal entity as much as any other company.[6] A company may control another company or an individual, or an individual may control a company, but it does not necessarily follow, because the individual controls the company, or the company controls the company, or the company controls the individual, that the business carried on by the person or company controlled is necessarily a business carried on by the controller.[7] But in a fit case the principle of piercing the corporate veil may be invoked. If a person who hold the beneficial interest in all or almost all the shares of company, causes such an arrangement to be entered into between himself and the company as constitutes the company as merely his agent for the purpose of carrying on his own business, the business will become for all taxing purpose his

[3] *Lakshminarayan v. Govt of Hyderabad* 25 ITR 449,460 (SC)
[4] *Upper Indian Chamber of Commerce v. CIT* 15 ITR 263,270
[5] Per Viscount Maugham, *Oddam v. Cook* 9 ITR Suppl 92,109 (HL)
[6] *OK Trust v. Rees* 23 TC 358 (CA); *IR v. Gramophone & Typewriter* 5 TC 358(CA); *IR v. John* 8 TC 20 (CA)
[7] *Juggilal v. CIT* 73 ITR 702 (SC); *Jindal v. CIT* 164 ITR 28

business and he himself would be assessable on the profits of the business.[8] Whether the company is a sham or simulacrum or mere cloak for the principal whose business the company carried on as the agent or nominee, is a question of fact depending upon the special circumstances of each case[9]. The burden of proving that the company is a sham or simulacrum, or mere agent or benamindar lies on the Revenue.[10] An assessment cannot be made on a company after it has ceased to exist and has been struck off the register of companies.[11] The company itself is chargeable to tax on its profits as distinct taxable entity, and its pays the tax in discharge of its own liability and not on behalf or as agent for its shareholders[12]. The result is that the shareholder is liable to tax in respect of the gross divided without ant credit for the tax assessed in the hand of the company. The company's tax is not to be confused with the shareholder's tax which, barring the specified cases, the company deducts at source under Sec 194 when paying the dividend and for which the shareholder gets credit in his own assessment.

2.1.2 Difference in Assessment

As regards liability to tax under this Act, broadly speaking, a company differs from other assessees in two respects:

- Under the Finance Acts the minimum taxable limit prescribed for other assessees does not apply in the case of a company' a company is liable to income tax, however small its income may be.
- A company has to pay income tax at a flat rate on the whole of its total income, whereas other assesses are taxed according to the gradual scale or slab system.

2.2 Indian company

An Indian Company means a company formed and registered under the Companies Act, 1956. Besides it includes the following[13]:

[8] *Stanley v. Gramophone & typewriter* 5 TC 385,374,380-81 (CA)
[9] Ibid
[10] *Dinshaw v. CIT* 2 ITC 255,269
[11] *CIT v. Express Newspaper* 40 ITR 38,56-57, on appeal 53 ITR 250 SC ; Modi v UOI 144 29
[12] *Howrah Trading v. CIT* 36 ITR 215,217-15 (SC); *Purshottamdas v. CIT* 48 ITR (SC) 206; *Lalita v. TISCO* 8 ITR 337,345; *Accountant General v. CIT* 16 ITR 78,87
[13] Sec 2(26) of the Income Tax Act, 1961; on the other hand a company which is not a domestic company is a foreign company.

a) A company formed and registered under any law relating to companies formerly in force in any part of India, other than the State of Jammu Kashmir and the Union territories specified in (e)
b) A corporation established by or under a Central, State or provincial Act
c) Any institution, association or body which is declared by the Board to be a company under Sec 2(7)
d) A company formed and registered under any law in force in the State of Jammu and Kashmir
e) A company formed and registered under any law for the time being in force in the Inion territories of Dadra and Nagar Haveli, Goa, Daman and Diu and Pondicherry.

In the aforesaid cases, a company, corporation, institution, association or body will be treated as an Indian company only if registered office is in India.

2.3 Domestic Company: It means a company or any other company, which in respect of its income is liable to tax under the Act, has made prescribed arrangement for the declaration and payment of dividends within India in accordance with Sec 194[14]. In other words, the definition of domestic company is made of two limbs (a) It is an Indian Company, and (b) it is any other company which in respect of its income liable to tax under the IT Act, has made prescribed arrangement for declaration and payment of dividend within India, of dividends payable out of such Income. In other words, if a company is an Indian company it will automatically be considered as a domestic company. In case of any other company, in order to become the domestic company it is essential that the said other company may have made the prescribed arrangement for declaration and payments within India of dividends out of such income. The second limb of the definition of the domestic company may even apply to the foreign companies. The condition regarding the arrangement to be made for the declaration and payment of dividend in India is required to be fulfilled by the companies other than Indian company.

Three requirements are to be satisfied cumulatively by a company before it can be said to be a company which has made the necessary arrangement for declaration and payment of dividend in India.

a) The share register of the company for all shareholder should be regularly maintained at the principal place of business in India, in respect of any assessment year, at least from April 1 of the relevant assessment year
b) The general meeting for passing of account of the relevant previous year and for declaring the dividends in respect thereof should be held on only at a place of business within India.
c) The dividends declared, if any should be payable only within India to all shareholders

2.4 Industrial Company: It means[14] a company which is mainly engaged in the business of generation and distribution of electricity or any other form of power or in the construction of ships or in the manufacture or processing of goods or in mining. A company is deemed to be mainly engaged in the business of generation and distribution of electricity or any other form of power or in the construction of ships or in the manufacture or processing of goods or in mining, if the total income of the previous year (before allocating deduction under Sec 80C and 80U is not less than 51 percent of such total income. However the Board, defines industrial company as:

a) A company which is mainly engaged in the business of generation and distribution of electricity or any other form of power or in the construction of ships or in the manufacture or processing of goods or in mining, even if the total income from such activities is less than 51 percent
b) A company which even though not mainly so engaged derives in any year 51 percent or more of its income from such activities

The following activities are held as "manufacturing" or "processing" of goods on the basis of judicial pronouncement"

- Book publishing
- Mixing of different types of teas to arrive at a desired blend

- Manufacture and selling of carpets but having major source of income from sales and import entitlement generated by exports of carpet
- Production of cinematographic films
- Tailoring cloths
- Conversion of computer cash voucher, invoices etc. into balance sheet, stock account etc.
- Sorting out, washing, drying and blending wool
- Undergoing a change in a commodity as a result of some operation (manual or mechanical) and as a result a new distinct commodity emerges

2.5 Company in which public are substantially interested: A company is regarded as a company in which public is substantially interested in the following cases[14]

1. Owned by Government or RBI: A company owned by the Government or the Reserve Bank or in which not less than 40 percent shares in terms of value are held by the Government or Reserve Bank or a corporation owned by the Reserve Bank
2. Section 25 Company: A company registered under Section 25 of the Companies Act, 1956 namely, companies for promotion of commerce, art, science, religious, charity, and prohibiting payment of any dividend to its members
3. A company without share capital: A company having no share capital and declared by the Central board of Direct taxes to be a company in which public is substantially interested
4. Nidhi or Mutual benefit Society: A company which carries on, as its principal business, the business of acceptance of deposits from its members and which is declared by the Central Government under Sec 620 A of the Companies Act to be a Nidhi or Mutual Benefit Society.
5. Company owned by a co-operative society: A company in which shares carrying not less than 50 percent of the voting power having been allotted unconditionally to or acquired unconditionally by, and are throughput the relevant previous year held by one or more co-operative societies.

[14] Sec 2(19) of the Income Tax Act, 1961

Listed company: A company which is not a private company and its equity shares are, as on the last day of previous year, listed on a recognized stock exchange of India

1. Public company owned by Government and/or widely held company: A company which is not a private company as defined under the Companies Act, 1956 and its shares carrying 50 percent of voting power (40 percent in cases of industrial companies) have been allotted unconditionally to, or acquired unconditionally by, or throughout the relevant previous year beneficially held by:
   - i. The Government; or
   - ii. A statutory corporation; or
   - iii. A company in which the public are substantially interested or a wholly owned subsidiary company

   The second subsidiary company of first subsidiary company (parent company listed in a recognized stock exchange of India falls within the term "wholly owned subsidiary company" notwithstanding the fact that neither the parent company nor is the first subsidiary company holding 100 percent shares in the second subsidiary company.

If the company is composed mostly of family members owning lion's share in the share capital, the onus to prove that it is a company in which public are substantially interested will be on the assesse.

2.6 Other companies: Investment Company means a company whose gross total income consists mainly of income which is chargeable under the heads " Income from house property", "Capital gains" and "Income from other sources". A company in which the public are substantially interested is known as widely held company and a company in which the public are not substantially interested is known as a closely held company.

Chapter 3 Residential Status and Tax Incidence

An Indian company is always resident in India.[15] A foreign company is resident in India only if during the previous year, control and management is situated wholly in India. In other words, a foreign company is treated as a non-resident if, during the previous year control and management of its affairs is either wholly or partly situated in India.

Place of Control	**Resident or Non Resident**	
	An Indian Company	**A company other than an Indian Company**
Control and management of the affairs of a company		
• Wholly in India	Resident	Resident
• Wholly outside India	Resident	Non-resident
• Partly in India partly outside India	Resident	Non-Resident

15 Sec 6(3) of the Income Tax Act, 1961; A company can never be ordinary or not ordinary resident in India

3.1 Meaning of control and management: The control and management of a business is situated in the place where, as was said in *San Paulo Brazillian Rly Co v. Carter* [18]' the head and brain of trading adventure' is situated; and the place of control may be different from the place where corporeal subjects of trading are to be found. Control of a business does not necessarily mean the carrying on of the business, and therefore, the place where trading activities or physical operations are carried on is not necessarily the place of control and management.[19] The control and management does not abide where a clever manager looks after the business[20]

Two alternative tests are provided for determining the residence of companies. A company is a resident (i) if it is an Indian company, or (ii) if the control and management of its affairs is situated wholly in India in the accounting year. Thus, every Indian company as that expression is defined in sec. 2(26), is deemed to be a resident in India even if its control and management is situated wholly or partly abroad, while a non- Indian company is deemed to be resident only if its control and management in situated wholly in India. A company registered abroad is a foreign company, but a foreigner can reside here and so can a foreign company[18]

In classic words of Lord Lorebum in *De Beers Consolidated Mines Ltd. v. Howe*[18], a company cannot eat or sleep but it can keep house and do business and for purposes income tax, a company resides where it really keeps house and does business, i.e where the central management and control actually abides[19] In law a company may have more than one residence[20] If the company is also resident elsewhere, that would not necessarily displace the residence in India under the Act[21]

While the locale of control and management is the sole test of residence for HUF, firms and other association of persons, it is an alternative test for companies. Again, a HUF, firm or other association of persons is resident here even if the control and management is partially situated here, while a non-Indian company's resident here only if the control and management is wholly situated here. A non-Indian company which is partially or wholly controlled abroad is to be regarded as non-resident. In English cases companies have been held to be resident if the control and management was situated substantially in the United Kingdoms[18], whereas this clause requires the control and management be 'situated wholly in India'.

The expression control and management in this clause is used in relation to 'affairs' and not 'business'. The expression 'affairs' may be said to be much wider than the expression 'business'; further the expression 'affair' means an affair which are relevant for the purposes of this Act and which have some relation to the income sought to be assessed.[19]

As a rule, the direction, management and control,' the head and seat and directing power' of a company's affairs is situated at the place where the directors meetings are held and consequently, a company would be resident in this country if the meetings of directors who manages and control the business are held here[18] The control and management would still be wholly situated in this country, although one or more of the directors may reside in a country where the company's physical undertaking and subjects of the trade are situated, provided their powers are delegated to them, by and their actions are subject to control of the board of directors in this country.[19] On the other hand if the action of directors residing abroad are not in fact subject to control of the directors in this country the control and management would not be situated wholly in India.[20] It is not what the directors have power to do, but what they actually do, that is of importance in determining the question of the place where the control is exercised, for as Lord Sumner said in Egyptian Hotel v. Mitchell[21] 'Where the directors forbore to exercise their powers, the bare possession of those powers was not equivalent to taking part in or controlling the trading. The control herein means de facto control and not de jure control.

The control and management of a company's affair is not situated at the place where the shareholder's meeting are held, even if one shareholder by reason of his holding an absolute majority of shares, has a decisive voice in matters relating to company's affairs.[18] The control of individual corporators is something wholly different from the management of the business itself. Nor is this principle less true when the holding of the individual corporators is so large that he is able to override the wishes of the other corporators in matters relating to the control of business company. The extent, but not the nature, of his power is changed by the magnitude of his holding. The control and management, the head and brain, does not reside where there is something ultimate power of control such as the power to control such as the power to alter articles of association by a special resolution or the power to interfere with fundamental finance nor where a clever manager looks after the business nor where dividends are paid and declared. A company may be a resident even if its entire trading operations are carried on abroad.[18] If the management and control is situated here, the company is resident here and if it does not in the least manner where the actual selling and buying of goods take place[19]

The leading case on the construction of this clause is *Subbaya Chettiar v. CIT*[18], which was concerned with the residence of a Hindu Undivided Family. The following proposition were established by the judgment of Supreme Court in this case:

a) Normally, a Hindu undivided family is presumed to be resident in India unless the assesse probes that the control and management of its affairs is situated wholly outside India. This clause is based very largely on the rule applied in England to cases of corporations. Generally speaking , the joint family, like the corporation in English law, resides where the central management and control actually abides. 'Control and Management' signifies the controlling and directive power, the head and the brain, and 'situated' includes the functioning of such power at a particular place with some degree of permanence.
b) The words 'affairs' in this clause means affairs which are relevant for the purposes of this Act and which have some relation to the income sought to be assessed. Mere activity by the family or its karta in a place does not create residence. The place of control, therefore, of residence, may be different from the place where the family does a great deal of business.
c) The seat of the management and control of the fairs of the family may be divided, and if so, the family may have more than one residence.

If the seat of management and control is abroad, it would need much more than 'activities' in India to support a finding that the seat of management and control had shifted or that a second center for such management and control had been started in India. Occasional or sporadic visits of non-resident karta to the place where the business of family is carried on in India or casual directions given in respect of business while on such visits would be insufficient to make the family resident in India. The foregoing principles apply equally to other association of persons[18]

It was laid down by the Supreme Court in *Erin v. CIT*[19], and *CIT v. Nandlal Gandlal*[20] approving decision of the Bombay High Court in *Naik v. CIT*[21], that the control and management means de facto control and management and not merely the right or power to control and manage.[22] The House of Lords held to the same effect in *Egyptian Hotels Ltd. v. Mitchell*[23] and *Bullock v. Unit Construction Pvt. Ltd*[24]. In Naiks case, a partner under the terms of the partnership deed had full power of control over the firms business, resided in India, while the firms business was carried on in South Africa. In the absence of any evidence that he in fact controlled and managed the firm's business from here, his residence was held to be insufficient to establish the residence of the firm in India.

3.2 Incidence of tax: Under the Act, incidence of tax on taxpayer depends on his residential status and also on the place and time of accrual or receipt of Income. In order to understand the relationship between residential status and tax liability, the meaning if 'Indian income' and 'foreign income' must be clear.

3.2.1 Indian Income: Any one of the following is Indian Income:

a) If income is received (or is deemed to be received) in India during the previous year and at the same time accrues(or arises or is deemed to accrue or arise) in India during the previous year
b) If income is received (or is deemed to be received) in India during the previous year but it accrues (or arises) out of India during the previous year
c) If the income received outside India during the previous year but it accrues (or arises or is deemed to accrue or arise) in India during the previous year

3.2.2 Foreign Income: If the following two conditions are satisfied, then such income is foreign income

a) Income is not received (or not deemed to be received) in India and
b) Income does not accrue or arise (or deemed to accrue or arise) in India

	Resident in India	Non-resident in India
Indian Income	Taxable in India	Taxable in India
Foreign Income	Taxable in India	Non-Taxable in India

The following conclusions can be drawn:

a) Indian income: Indian income is always taxable in India irrespective of the residential status of the tax payer
b) Foreign Income: Foreign income is taxable in hands of resident of India, and is not taxable in hands of non-residents in India

3.3 Permanent Establishment and Business Connection

Tax treaties of specific countries are negotiated on the basis of the Organization for Economic Co-operation and Development [Hereinafter, "OECD"] model, the United Nations model, and the United States model. Tax regimes are confined to specific countries, although multinational enterprises have a global reach. Each jurisdiction enacts its own country-specific tax rules. India is no exception to the above arrangement. Hence, while computing the tax treatment of a non-resident in India, the provisions of the Agreement for Avoidance of Double Taxation [Hereinafter, "DTAA"] between India and the country of which the non-resident is a tax resident are considered. As per the provisions of the Income Tax Act, 1961 [Hereinafter, "the Act"], the taxability of non-residents is governed either by the Act or the DTAA, whichever is more favorable.

The Act deals with the concept of a business connection between a resident and a non-resident. Where there is an intimate and real relationship between the two on a continued basis, the non-resident becomes liable for tax in India in respect of income earned, pertaining to a business connection, that is deemed to accrue in India. For a non-resident, only that income is subject to tax in India that, inter alia, accrues or arises, or is deemed to accrue or arise, in India.[16] In this regard, any income accruing or arising, directly or indirectly, through or from a 'business connection' in India to a non-resident, is deemed to accrue or arise in India and hence, such income is taxable in India.[17] The term 'business connection' is very wide and what constitutes the same has been the subject matter of judicial scrutiny in a large number of cases. Business connection may take several forms: it may include carrying on a part of the main business, or activity incidental to the main business of the non-resident through an agent, or a relation between the business of the non-resident and the activity in India, which facilitates or assists the carrying on of that business[18].

Sec. 9 of the Act, which deals with business connection, stands superseded where the non-resident is residing in a country with which India has entered into a DTAA. Under such an agreement, business profits are taxable under Art. 7, provided such profits are attributable to the permanent establishment [Hereinafter, "PE"] defined by Art. 5 of the DTAA. Art. 5 of the DTAA will apply where an enterprise carries on a business, whether wholly or partly, through a fixed place of business.

The issue that arises from such outsourcing of business is the attribution of income to a PE. This has become a subject of debate over the recent years. The PE concept as it is understood in international tax law provides the basic threshold limit beyond which a multinational enterprise can be taxed in the source jurisdiction of the business activity.

The concept of a PE is not alien to the Indian tax system. Generally under Art. 7 of the tax treaties (dealing with taxation of business profits), a contracting State (such as India) cannot tax the profits of an enterprise of the other contracting State (such as the US), unless the enterprise carries on its business in India through a PE situated therein. There are circumstances in which a foreign customer can be deemed to have a PE in India, in which case certain attributable profits of such customer will be taxable in India. Therefore, from a non-resident company's perspective, the structuring of the outsourcing contract, the examination of the PE exposure and the adoption of measures to mitigate risk become very critical.

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[16] Sec. 5 of the Income Tax Act,1961

[17]Sec 9 of the Income Tax Act,1961

[18] *Commissioner of Income Tax v. R. D. Aggarwal & Co*., [1965] 56 ITR 20 1964 SC 254

Let us understand the concept of a PE in a typical outsourcing arrangement by way of an illustration. A foreign enterprise (say "XYZ Inc.") contracts out some of its business functions to its Indian subsidiary (say "XYZ India"). In the course of the outsourcing arrangement, XYZ Inc. undertakes the following:

1. Preliminary quality control of XYZ India's deliverables; and
2. Training of XYZ India's personnel by employees of XYZ Inc. to maintain quality and standards.

Further, XYZ Inc. allows XYZ India to use its hardware, systems or software to perform services and transmit data in a secure manner. On an as-needed basis, XYZ Inc. and its employees have access to XYZ India's premises for inspection purposes, to the extent required by XYZ Inc. to comply with its obligations under the agreement. Moreover, in certain circumstances, XYZ India also provides the representatives of XYZ Inc. office space, furniture, cabinets etc., to the extent required.

XYZ India employs a dedicated pool of personnel at a level set by XYZ Inc., to provide the services. XYZ India also follows the HR policy of XYZ Inc. However, XYZ Inc. retains authority and supervision over XYZ Inc.'s business-related decisions, including business rules and strategic direction, among others, which are relevant for the delivery of services. Based on this fad summary, can XYZ Inc. be reckoned as having a "Fixed Place PE" in India; or can it be reckoned as having a "Service PH" due to the activities of its employees?

3.3.1 Fixed Place PE

Generally, the PE of the foreign enterprise in India is a fixed place through which the business of a foreign enterprise is wholly or partly carried on. A fixed place PE can arise due to the activities of the non-resident's Indian subsidiary or due to the existence of the foreign enterprise's employees in India. For a foreign enterprise to be reckoned as having a fixed place PE in India, it should satisfy the following three conditions:

1. Existence of a "place of business";
2. "Right to use" the place of business; and
3. Carrying out the business "through" that place.

In this context, it must be noted that significant Indian jurisprudence on this issue has emanated, by placing reliance on the OECD Model Commentary. As per the Commentary on Art. 5 of the Model Tax Convention [Hereinafter, "OECD MC"], a "place of business" covers any premises used for carrying on the business of the foreign enterprise, whether or not used exclusively for that purpose. Further, the OECD MC clarifies that the premises need not be owned or even rented by the foreign enterprise, provided they are at the disposal of such enterprise. The commentary of OECD on Art. 5 also states that there must be a fixed place of business, which takes in not only fixed premises but also machinery or equipment. The expression "a fixed place" indicates a certain degree of permanence. It is necessary that the business of the enterprise be carried on through a fixed place. Art. 5 of the DTAA is an inclusive provision that takes in various places and services enumerated in clauses (a) to (i). A number of places are specified in clauses (a) to (k), whereas clause (I) postulates the provision of services by an enterprise within a contracting State, through employees or other personnel.

The OECD MC gives certain examples to illustrate what is meant by premises at the disposal of an enterprise. One such example refers to the employee of a company ("A") being allowed to use an office in the headquarters of another company ("B") in order to ensure that B complies with its contractual obligations with A. In this regard, the OECD MC states that B's office will constitute A's PE, provided that it is at A's (or its employees') disposal for a sufficiently long period of time so as to constitute a "fixed." place of business, and the activities are not in the nature of preparatory or auxiliary activities[19].

Therefore, in principle, the OECD MC concludes that a place of business is at the disposal of an enterprise if it has some right to use the premises for the purposes of its business and not solely for the purposes of the project undertaken on behalf of the enterprise.

From an Indian tax jurisprudence perspective, the Andhra Pradesh High Court, while interpreting a similar clause in the DTAA between India and Germany, has held that a PE postulates the existence of a substantial element of an enduring or permanent nature of a foreign enterprise, which can be attributed to a fixed place of business in India. It should, by its character, amount to a virtual projection of the foreign enterprise in India.[20]

In an important case, another aspect of a Fixed Place PE was discussed. The employees of Motorola, Inc. rendered certain services from the office of Motorola's Indian subsidiary.

[19] OECD, *Model Tax Convention on Income and on Capital*: Condensed Version, 93 (2010).

[20] *Commissioner of Income Tax v. Vishakhapatnam Port Trust*, (1983) 144 ITR 146 1983 (AP) [Andhra Pradesh High Court].

The salary of these employees was borne by Motorola, Inc. However, the perquisites were borne by the Indian subsidiary. Further, the employees also performed certain services for the Indian subsidiary. The Income Tax Appellate Tribunal [Hereinafter, "the Tribunal"] ruled that these employees worked for Motorola, Inc., in India. They used the office of the Indian subsidiary to carry on Motorola, Inc.'s work, and thus, there was a projection of Motorola in India in the Indian subsidiary's office. It was held that the Indian subsidiary was a fixed place of business of Motorola, However, it was ultimately held that the Indian subsidiary's activities were preparatory or auxiliary in nature, and therefore, Motorola, Inc. did not have a Fixed Place PE in India, In this case, Nokia was also a party, and it had a wholly owned subsidiary In India. Nokia's Indian subsidiary was engaged in supporting Nokia's main activities[21]. The Tribunal held that Nokia had a PE in India as the Indian subsidiary's nature of activities was much more than just preparatory or auxiliary. However, Ericsson, which was the third party in this case, was held not to have a PE in India because, although Ericsson's employees performed certain services using the office of Ericsson's Indian subsidiary, they in fact had no right to enter the Indian subsidiary's office to carry on Ericsson's activities. Therefore, the Tribunal concluded that Ericsson had no PE in India through its Indian subsidiary.

In the case of eFunds Corporation [Hereinafter, "eFunds USA"), eFunds USA had an Indian subsidiary that provided certain 'back office' services to it. The Indian subsidiary bore limited risks, had little-to-no assets, and relied on eFunds USA for performing the services. The most significant issue before the Tribunal was regarding the existence of eFunds USA's permanent establishment in India. The tax authorities, on the basis of the Group Annual Report, held that the facilities of eFunds India were at the disposal of eFunds USA and that it was eFunds USA's business that was carried out in India. Therefore, the income earned in connection with such services rendered in India should be considered as derived, and hence taxable, in India. On the other hand, eFunds USA contended that the premises of eFunds India were never at the disposal of eFunds USA. Further, the sales outlet whose presence was stated in the Group Annual Report was of eFunds India, and not of eFunds USA, and therefore, such premises should not constitute a PE for eFunds USA in India. Further, it was contended that only back office operations were being carried on

[21] *Motorola, Inc. v. Deputy Commissioner of Income Tax*, (2005) 96 TTJ ITAT 74 (ITAT Del)

in India, and these operations were preparatory and auxiliary in nature and therefore, not the core business activity of eFunds USA. Here, the Tribunal ruled that the Indian subsidiary was not an independent contractor, but a "partner in business" owing to which it was deemed to be eFund USA's PE in India. The facilities of eFunds India were at the disposal of eFunds USA. eFunds USA and eFunds India were viewed as partners in business as they were under a legal obligation to provide services to eFund's clients under the same contract, and as eFunds India did not bear any significant risk as the ultimate responsibility vis-à-vis the eventual client was with eFunds USA. [8] The Tribunal's observation was based on the Form 10K filed by eFunds USA[22] according to which its activities in India were not preparatory or auxiliary; rather, they were core income generating and thus this contention of eFunds USA was also rejected.

In the case of *Rolls Royce PLC v. Director of Income Tax*,[23] the Delhi Income Tax Appellate Tribunal considered the taxation of a multinational enterprise selling its products in India. Rolls Royce PLC, a UK-resident company, was engaged in the business of supplying airplane engines to Indian customers. Rolls Royce PLC's India office provided it with marketing support services and was compensated on a cost-plus basis for its services. The Delhi tribunal held that Rolls Royce PLC had a fixed place of business in India as its employees visited India frequently and the Rolls Royce India premises were used and occupied during such visits. The Delhi tribunal held that Rolls Royce PLC also had an agency PE since the activities of the India office resulted in it soliciting orders wholly and exclusively on behalf of Rolls Royce PLC.

In another case dealing with the creation and existence of a PE and income attribution in the context of a business using digital and Internet technology, in Galileo International Inc. v. Deputy Commissioner of Income Tax[24]the Delhi tribunal again ruled in favor of a fixed place of business. Galileo, a US company, owned a computer reservation system [Hereinafter, "CRS"] located in the US This system was accessed by unrelated travel agents

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[22] *Funds Corp. v. Assistant Director of Income Tax*, 2010-TII-165-ITAT-DEL-INTL

[23] *Rolls Royce PLC v. Deputy Director of Income Tax*, (2007) 19 SOT 42 (Del [Hereinafter, "Rolls Royce Plc."].

[24] *Galileo International Inc. v. Deputy Commissioner of Income* Tax, 447-1TAT-DEL 2007 ITAT 215 [Delhi Income Tax Appellate Tribunal].

in India using hardware, software and connectivity provided by Galileo. Galileo appointed an unrelated distributor in India that was responsible for initiating relationships and signing subscriber agreements with these travel agents in India. Although the distributor was remunerated by Galileo, the travel agents were paid directly by the airlines for successful bookings. The Delhi Tribunal ruled that Galileo had a fixed place of business in India as the CRS extended to India through telecom networks, and that Galileo carried on business in India through computers installed on travel agents' premises in India.

Based on the OECD MC and Indian rulings, it is possible that XYZ India may be considered to be a place of business of XYZ Inc., if a part of XYZ Inc.'s business (core income generating activities) is carried on at XYZ India's premises. Additionally, if XYZ Inc. (or its secondees) has an exclusive uninterrupted right to use XYZ India's premises, there can be Fixed Place PE exposure.

3.3.2 Measures to mitigate Fixed Place PE

To the extent possible, XYZ India should be an independent contractor providing services to XYZ Inc. on an arm's-length basis under the Agreement. Additionally, XYZ India should have the sole right to supervise, manage, control, direct, procure, perform, or cause to be performed, all necessary work, duties or obligations as per the terms of the agreement. In no event should XYZ Inc. control XYZ India's business or its internal management, XYZ Inc. can, however, undertake stewardship activities (limited to quality control activities, and briefing and providing preliminary training to personnel involved in delivering the services).

Additionally, most DTAAs do not consider a fixed place to be a PE of a foreign enterprise if the place is maintained solely for activities that have a preparatory or auxiliary character. As per the United States DTAA, a fixed plats maintained solely for the purpose of advertising, for the supply of information, for scientific research or for other activities that have a preparatory or auxiliary character for the enterprise will not be considered as the PE of the American enterprise.[25] However, the United States DTAA does not define the terms 'preparatory' or 'auxiliary' activities. Since most DTAAs do not define the term, it becomes

[25] Art. 5 (3) (e) United States Double Taxation Avoidance Agreement.

difficult to distinguish activities that have a preparatory or auxiliary character from those that do not.

The decisive criterion is whether the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. [12]

The Supreme Court of India has held that an Indian enterprise performing 'back office' functions supporting the front office, such as fixed income and equity research, IT-enabled services such as data processing, support center and technical services, and reconciliation of accounts, for an American enterprise, would be carrying on activities that can regarded as preparatory or auxiliary, and hence, the same would not result in a Fixed Place PE for the American enterprise in India.[26]

The Tribunal has also held in Rolls Royce Plc. [14] that it is often difficult to distinguish between the main activities of an enterprise and those activities that have a preparatory or auxiliary character. The Tribunal has pointed out that each case has to be examined on its own merits. The essential and significant activities, within the framework of the business purpose of the enterprise, constitute the core business activities, and the business operations in the nature of the core business activities invariably constitute a PE[27]

In another case, the Delhi High Court has held that the term 'auxiliary' connotes activities that can be described as "aiding or supporting", or "subsidiary" to, the main business[28]. The case involved a United Arab Emirates [Hereinafter, "UAE"] company that was engaged in the business of remitting money from the UAE to India under instructions from expatriate Indians residing in the UAE. Once a customer gave an order for a remittance in the UAE, the company's liaison offices in India would download the details, arrange for the banker's drafts, and deliver them to the beneficiary. The Delhi High Court stressed that any activity that aids or supports the main activity should be reckoned as auxiliary to the main business. In this matter, the Court held that the activities of the Indian liaison offices were only aiding and supporting the principal business activity being carried out in the UAE.

However, this exemption is not available if the Indian enterprise performs activities that are considered to be core income generating activities of the foreign enterprise.

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[26] *Director of Income Tax v. Morgan Stanley Co. Inc*., 292 ITR 406 (SC)

[27] *Pioneer Overseas Corp. v. Assistant Director of Income Tax*, (2010) 131 TTJ (Delhi) 409

[28] *UAE Exchange Centre v. Union of India*, (2009) 223 CTR (Del) .

3.3.3 Service PE

Generally, if an American company (a) deputes employees Or other personnel to India, and such personnel stay in India for more than ninety days within a twelve month period and render services other than 'included services', or (b) renders the above services for an 'associated enterprise', then it is regarded as having a PE in India.[29].Additionally, two enterprises are cumulatively referred to as associated enterprises when (i) one enterprise participates, directly or indirectly, in the management, control or capital of the other enterprise, or (ii) the same persons participate, directly or indirectly, in the management, control, or capital of both enterprises, and the commercial or financial relations between the enterprises are not being conducted at arm's-length.[30]

In addition, 'included services' mean the rendering of technical or consultancy services (including through the provision of the services of technical or other personnel) where such services (i) are ancillary or subsidiary to the application or enjoyment of; (a) various intellectual property rights such as patents, copyrights, trademarks etc. (b) design or model, plan, secret process, information concerning industrial, commercial or scientific experience etc. (c) any industrial, commercial or scientific equipment, or make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.[31]

However, the following services are excluded from the purview of included services: (i) services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property (ii) services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic (iii) teaching in or by educational institutions (iv) services for the personal use of the individual or individuals making the payments or (v) professional services (as defined in Art. 14 of the United States DTAA) provided by an employee to any individual or firm of individuals[32]

Therefore, based on the above provisions, a foreign enterprise can be deemed to have a Service PE in India if it deputes employees or other personnel to India, and such personnel

[29] Art. 5 (2) (1), United States Double Taxation Avoidance Agreement.
[30] Art. 9, United States Double Taxation Avoidance Agreement.
[31] Art 12 (4), United States Double Taxation Avoidance Agreement.
[32] Art. 12 (5), United States Double Taxation Avoidance Agreement.

stay in India for more than the period specified in the DTAA to render services other than included services, as defined in the DTAA. In the above mentioned transaction, XYZ Inc. is deputing its employees to India for carrying out various activities such as training, developing and supervising the work performed by the Indian employees.

The concept of stewardship as an exception to the creation of a Service PE was first discussed by India's Authority for Advance Rulings [Hereinafter, "AAR"] in the Morgan Stanley case,[33] which was reviewed by the Supreme Court on appeal.[34]Here, Morgan Stanley Incorporated [Hereinafter, "MS Inc."] was obliged to depute various employees to its Indian subsidiary, Morgan Stanley Advantage Services (Hereinafter, "MSAS"], who could be classified into:

1. Deputationists performing managerial functions for MSAS; and
2. Employees performing stewardship functions, i.e., monitoring the progress of the work being performed by MSAS for MS Inc

In this context, the Supreme Court ruled that stewardship activities would not amount to a service and, therefore, the employees performing such activities would not lead to MS Inc. having a Service PE in India. However, the activities performed by the deputationists were in the nature of services being rendered by MS Inc. to MSAS, and this would constitute a Service PE if such services were rendered by them while still on the payrolls of MS Inc., or if they retained a "lien" on employment. The Court did not specify what constituted a lien, but, generally, this would mean a right to be employed by MS Inc. even if the deputationists were currently on the payroll of MSAS.

As regards the pure stewardship activities performed by XYZ Inc's employees in relation to services provided by XYZ India, there should be little risk of being held a Service PE. However, if some of XYZ Inc.'s personnel are on deputation and retain their original jobs with XYZ Inc., or have a lien on employment, then there will be a greater chance of being classified a Service PE if they stay in India for periods longer than those provided in the DTAA.

3.3.4 Measures to mitigate Service PE

The overall risk of being held a service PE can be mitigated:

[33] *In Re: Morgan Stanley and Co.*, [2006] 284 ITR 260 2006 (AAR) [Supreme Court of India].

[34] *Director of Income Tax v. Morgan Stanley and Co. Inc*., [2007] 292 ITR 416 (SC) 739 (SC)

1. If the deputationists act under the supervision and control of the Indian enterprise;

2. If the deputationists do not represent, or render any services on behalf of, the foreign enterprise;

3. If the foreign enterprise does not bear the risk of the deputationists' actions while they are in India; and

4. Such risk is completely attributable to the Indian enterprise's account.

3.3.5 Conclusion

Since India has emerged as a key outsourcing hub for a number of multinational enterprises, the Indian tax authorities have been aggressively trying to include multinationals operating in India within the tax net in the recent years. In such a scenario, it becomes pertinent for the foreign companies to carefully assess their current and potential outsourcing transactions in India and the PE implications that emanate from them.

In order to avoid a potential PE risk, the assessment made by the enterprises should be risk-based, and advice should be obtained on the risk of scrutiny and litigation because of the uncertainty regarding what constitutes control, back office functions and core income generating activities. This helps in formulating the law, providing clarification for various judicial proceedings and introducing various concepts to make the interpretation of the law simpler. An alternative plan of action, to avoid this risk, is to obtain a ruling from the AAR on whether a contemplated outsourcing activity creates a tax liability for the customer in India. The advantage of such a ruling is that it is not only binding on the tax payer and the tax authorities, but also provides for a degree of certainty. However, it is to be noted that obtaining such a ruling may take a time period of around six to eight months period of around six to eight months.

3.4 Vodafone case and its consequences

The petitioner (Vodafone International Holding BV hereinafter ‘V’) challenged a decision by the Indian tax authorities that it had failed to deduct tax at source as required by the Sec 195 of Income Tax Act 1961 (India). V, a Dutch company, had acquired a controlling interest in an Indian company (Hutchinson Essar Ltd hereinafter HEL) when it bought a share in a Cayman Islands company (C), which owned shares in H. The vendor was a Cayman Islands company which was part of a Hong Kong group, and V made the payment to a group subsidiary, which was also a Cayman Islands company. The Indian Revenue decided that capital gains tax (CGT) was chargeable on the share sale and, under s.195, V should have deducted the tax from the payment made to the vendor's subsidiary. V submitted that the transaction was only in respect of one share of C and that being a capital asset situated outside India, there was no accrual or deemed accrual of income in India, and so the obligation to deduct tax under s.195 did not arise. The Revenue, however, maintained that there had been a composite transaction involving a transfer of rights in H resulting in an accrual or deemed accrual of income for the vendor from a source of income, asset or transfer of a capital asset situated in India.

(1) It was held in para 56 of judgment that Indian law recognizes that an assessee who engaged in legitimate business activity and organized business around accepted legal structures was entitled to plan his transactions in a manner that would reduce the incidence of tax. But that was not the case where the transaction was a sham, namely one which was different in reality from the legal form employed by the parties. (2) Further in para 77, the jurisdiction of a state to tax non-residents was based on the existence of a nexus connecting the person sought to be taxed with the jurisdiction which sought to tax. Such a nexus arose where the source of income originated in the jurisdiction. (3) As provided under para.132, it was held that the facts clearly established that it would be simplistic to assume that the entire transaction was fulfilled merely upon the transfer of a single share of C in the Cayman Islands. The commercial and business understanding between the parties postulated that what was being transferred from the vendor to V was the controlling interest in H. At all times, H was intended to be the target company and a transfer of the controlling interest in it was the purpose which was achieved by the transaction. Therefore, V's submission that the transaction involved merely a sale of a share of a foreign company from one non-resident company to another could not be accepted[35]

On 16 March 2012 India pronounced plans to generate retrospective changes to the law that would commendably reverse the decision of the Supreme Court and let India to tax non-residents on gains as a result of the disposal of oblique interests in Indian companies, potentially as far again as 1962. This changes include an obligation using a non-resident purchaser connected with interests in Indian assets to withhold a sum in respect, connected

[35] Para 136 of the judgment

with Indian tax. The government has also proposed a diverse general anti-avoidance principle. The proposals met with popular criticism. Industry bodies as well as governments are lobbying the government of India to reexamine.

3.4.1 Retrospective Counteraction

As part of its 2012 budget, the Indian government announced a chain of debatable measures on 16 March 2012 to expand the grasp of its tax net. These covered indirect transfers of Indian assets, included a GAAR, withholding, and limitation periods,

3.4.1.1Indirect transfers of Indian assets

Indirect transfers of Indian assets by non-residents, covering transfers back to 1 April 1962 would be taxable, including transfers of shares in companies which derive their value "substantially from assets located in India. There exists an ambiguity as to whether the Indian tax authorities would indulge in practice to tax relevant transactions dating back half a decade, or whether they would abide and be bound by relevant limitation periods. The critics have raised their voice that the legislation does not contain the definition of the term "substantially", and beyond the OECD Model Tax Convention which allows tax to be levied only on a sale of a non-resident company's shares where those shares derive more than 50% of their value from real estate assets in the relevant jurisdiction.

3.4.1.2 Withholding

- With retroactive effect to 1962, any person responsible for paying a sum that is subject to Indian tax would have to withhold an amount in respect of that Indian tax. This rule applies equally to non-residents and residents, notwithstanding whether a non-resident payer has any connection with India.
- Any person paying an amount to a non-resident and falling within a class to be designated by the Indian authorities would have to apply to them for a decision on whether withholding tax was due, regardless of whether or not any tax was ultimately due in India.

3.4.1.3 Limitation periods

- The limitation period for tax assessments has been extended from 6 years to 16 years in respect of taxable income relating to a non-Indian asset including a financial interest in any entity

3.4.1.4 GAAR

- A new general anti-avoidance rule would allow the Indian authorities to challenge "impermissible avoidance arrangements". The burden lies on the taxpayer to refute the hypothesis that obtaining a tax benefit is the main purpose of the arrangement.

The GAAR would also give the Indian Tax Office broad discretion to override arrangements under India's double tax treaties. Traditionally, much investment in India has been made through Mauritius: the India/Mauritius treaty offers particularly generous benefits. There is concern that the Tax Office might be able to invoke the GAAR to deny treaty benefits to investors.

3.4.2 Vodafone's Reaction

On 17 April 2012 VIHBV announced its intention to bring arbitration proceedings against the Indian government under the Netherlands/India Bilateral Investment Treaty if the budget proposals are not dropped or suitably amended.

3.4.3 International Reaction

The amendments have "dampened enthusiasm" for international investment in India and it is stressed that stable tax system is sine qua non for cross-border development. In addition to the intervention of industry bodies such as the Business and Industry Advisory Committee to the OECD, a seven-party consortium of trade and business associations across Europe, North America, and Asia, and politicians, have also complained to the Indian government about the measures.

On 20 April 2012 the Indian government proclaimed that cases assessed and finalized up to 1 April 2012 cannot be reopened following the 2012 budget. However, several other cases may be affected by amendment. Even though the Indian assets of Cadbury represented only a small percentage of the total value of the transaction, Kraft's 2010 acquisition of Cadbury and SABMiller's 2006 acquisition of various assets (including

Indian assets) from Australian brewer Foster's Group is also under review by the Indian Tax Office. Despite pervasive global concerns, the Indian government has described the amendments as mere "clarification" of the existing law rather than an refurbishment of the taxing structure.'

Chapter 4. Different kind of Taxes levied

4.1 Minimum Alternate Tax

Minimum alternate taxation is a result of counter action by the legislature to the practices of companies that declare substantial profits and at the same time pay low or no taxes. Such companies are also called zero tax companies. The experimentation approach of the parliament with regards to MAT was visible when it was introduced in 1983 and it continues to do so in the proposed Direct Tax Code.

4.1.1 Introduction: The statutory features of Indian tax system like exemption, deductions and rebates had allowed the companies to circumvent the Indian tax system and reduce their tax liabilities. The amendment to Income Tax Act, 1961 by the parliament is a cure to this mischief.

4.1.2 Objectives of MAT regime: The concept of MAT owes its origin under the ITA to tax 'zero tax' companies, i.e., companies that make high book profits and declare substantial dividends to their shareholders but have no or insignificant taxable income under the ITA because of the exemptions, deductions and incentives provided therein in the form of a liberal rate of depreciation, sector and region-specific exemptions, deductions etc. MAT is in consonance with a fundamental canon of taxation– all entities must be taxed in proportion to their ability to pay[63]. The current MAT regime under the ITA is similar to the first such regime– the US Alternate Minimum Tax ('AMT').[64] As with the Indian law, the legislative intent for introducing this kind of taxation was to ensure that "no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits"[65] It is pertinent to note that AMT applies to 'all taxpayers' including individuals and companies. In contrast, the provisions of MAT under the ITA are applicable only to companies and limited liability partnerships.[66]

The intention of the taxation regime in both jurisdictions is, however, the same– to curtail the benefits of various exemptions and deductions if they results in little or no tax liability.

4.1.4 MAT under Sec.115JB: Under the provisions of the ITA, every company, domestic or foreign, is required to pay MAT. As per Sec.115JB, where the income tax computed under the Act in respect of any previous year relevant to the assessing year, is less than 18.5 percent of its book profits, such book profit shall be deemed to be the total income of an assessee and tax payable on such total income shall be 18.5 percent of the same[63]. The term book profit has been defined in the ITA itself. Book profit means the net profit as shown in the profit and loss account for the relevant previous year as determined by the provisions of Parts II and III of Schedule VI to the Companies Act, 1956, with certain positive and negative adjustments.[64] The objective of making these positive and negative adjustments with net profit is to ascertain the true and genuine profit of the company. Under the Companies Act, this profit and loss account must be maintained as per provisions of the said Act and be presented before its shareholders at its annual general meeting. As this is the basis on which investments in the company are made, there is a low chance of the company manipulating this account to show a lower profit and making investment in the company less attractive. Certain important features and controversial provisions of the current MAT regime are explained below.

4.1.5 Constitutionality of MAT regime: At the outset, it would be relevant to analyze the constitutional validity of the MAT. Several arguments have been raised against the constitutionality of MAT. First, it has been argued that by leaving it to the government to decide what constitutes 'deemed income', the provision may suffer from potential arbitrariness in the exercise of this power by the government. In addition, it only singles out the 'zero-tax companies' for the purpose of taxation under MAT, thereby ignoring the fiscal burden discharged by them generally. In a number of decisions, however, courts have rejected any such constitutional challenge to the MAT provisions.[63] In addition, companies are also liable to pay surcharge if their total income exceeds Rs. 1 crore. The surcharge rate, as amended by Finance Act, 2011, for domestic companies and companies other than domestic companies, i.e., foreign company is 5 percent and 2 percent of such income tax respectively. Like other assesses, companies also pay education cess @ 3 percent.

4.1.6 MAT credit: MAT credit is a beneficial provision for companies based on principles equity. In a given assessing year, when a company pays tax under the MAT provisions as opposed to the general provisions of the ITA, the excess of tax so paid over and above the tax payable under the general provisions of the Act, accrues as tax credit to the company[63]. Thus, MAT credit is the difference between the tax calculated under the provisions of MAT and the tax calculated under the general provisions of the ITA (i.e., normal tax liability). Such credit is allowed to be carried forward and set-off against the income tax liability in an assessment year in which the company is liable to pay tax under the general provisions of the ITA (and not under the MAT provisions), to the extent of such tax payable over and above the book profits in that assessment year. MAT credit can be carried forward and set-off for ten assessment years immediately succeeding the assessment year in which the tax credit was first computed.[64] Thus, companies must always calculate their normal tax liability and their liability under the MAT and pay whichever is higher. If, however, the company pays MAT in an assessment year, then it can avail of credit over and above normal tax liability. This means that in no year will the company pay tax less than the MAT tax rate. The table below shows how MAT credits accrue to companies and how they may be set-off:

Assessment Year	Tax under the general provisions of the ITA i.e. normal tax liability	Tax payable under Sec 115JB, i.e. MAT	Tax payable by the company	MAT credit	MAT Credit Set-of	MAT Credit Carried forward
2008-09	100	120	120	20	-	20
2009-10	150	160	160	10	-	20+10=30
2010-11	200	190	190	-	10	10+20=30
2011-12	300	200	280	-	20	-

4.1.7 Advance Payment of Tax: Under the ITA, every assessee is required to pay an advance tax on their income (i.e., current income) if advance tax liability as computed in accordance with the provisions of Chapter XVII of the ITA, is Rs. 10,000 or more during the financial year.[63] One of the interpretational quandaries that has arisen with respect to Sec.115JB is whether companies that pay MAT are liable to pay advance tax. Companies that make default in the payment of advance tax are subject to penalties under Sec.234B and 234C of the ITA. The Karnataka High Court, in *Kwality Biscuits Ltd. v. Commissioner of Income Tax*[64], held that the penalties prescribed under Sec.Sec.234B and 234C do not apply where a company pays the MAT.

It held that since the exercise of computing income under Sec.115JA can only be done at the end of a financial year, the provisions relating to advance payment of tax were not applicable. This is because until accounts are audited and balance sheets prepared, the assessee will not be able to determine whether Sec.115JA is applicable or not. The respondent filed a Special Leave Petition before the Supreme Court against this decision. The Supreme Court dismissed the petition through a non-speaking order on April 26, 2006.[63]This case has subsequently been followed in a number of disputes.[64] On the other hand, some courts have not shared the view of the Karnataka High Court and decided the issue against the assessee. For instance, in *Jindal Thermal Power Company Limited v. Deputy Commissioner of Income* Tax, the Karnataka High Court distinguished its own decision in Quality Biscuits and held that Sec.115JB is a self-contained code regarding the MAT liability of companies.[65]Therefore, where such companies defaulted in the payment of advance tax, they were liable for payment of penalties under Sec.Sec.234B and 234C of the ITA. Finally, the Supreme Court in its speaking order dated January 7, 2011 has brought to an end the controversy, deciding that companies paying tax under the MAT provisions had to pay advance tax and were liable for penalties in case of default as per law.

4.1.9 MAT under DTC Code Bill, 2010: The Direct Tax Code Bill as introduced in the Lok Shabha on August 30, 2010, aims to replace ITA and improve the efficiency and equity of the direct tax system by eliminating distortions in tax structure, introducing moderate levels of taxation and expanding the tax base.[63] The numerous amendments to the ITA and multitude of judgments, often conflicting, have made the ITA very complicated for the tax payers and the department. Given that the cost of compliance is essentially regressive in nature, the equity of the tax system is undermined. The DTC seeks to move towards a simplified and rational regime for direct taxes. The provisions relating to MAT are, however, largely similar to those in the current ITA. The current draft of the DTC Bill provides, inter alia, for the levy of MAT on companies at the rate of 20 percent of the book profits, of the company without any surcharge and cess. Sec.105 provides that companies must maintain a profit and loss account in accordance with the provisions of the Companies Act and that such an account shall be treated as the book profit of that company. The DTC also includes a provision for MAT credit. While the initial draft of the DTC did not contain any provision for MAT credit, the current draft, in Sec.106 (4), provides that MAT credit accrues to a company in a financial year in which a company is liable to pay tax under MAT. This credit can be carried forward and set-off for five financial years immediately succeeding the financial year in which the credit was first computed. Under Sec.205, the DTC also provides for the payment of advance tax with respect to the total income, if such tax is more than ten thousand rupees during any financial year. Sec.205 (2) provides for the calculation of advance tax. Moreover, Sec.205 (4) provides that a company is liable to pay this advance tax in four instalments according to the schedule prescribed therein.

4.1.9 Problems with Present Regime: As discussed above, MAT was first introduced in the ITA in order to address the problem of zero-tax companies by ensuring that such companies pay an adequate amount of tax to the government. The regime has, however, made the ITA more complicated, leading to high cost of compliance and administration. As outlined above, the introduction of MAT requires companies to calculate their taxable income by both the general provision of the ITA and by the provisions of the Companies Act relating to calculation of book profits. This increases the costs for record-keeping and compliance on companies. When the AMT was introduced on companies in the US, studies showed that firms spent 18 percent more on compliance costs where such tax was applicable to them.[63] In India as well, MAT is identified as a 'legal hot spot' that increases costs of compliance.[64]

This is further complicated by the fact that all companies that are liable to be taxed under Sec.115JB are also liable for payment of advance tax.[65] Therefore, these two sets of accounts must be maintained and submitted periodically by a company over the year and under Sec.234B and 234C, they can be subject to penalties for default of such payments.[66]In addition, liability under the MAT has prompted companies to post lower profits by changing their accounting policies. These accounting practices would undoubtedly have an adverse impact on companies, investors and stakeholders because displaying lower book profits lowers their reputation with the potential investors and shareholders do not receive adequately accurate information regarding the financial operation of the company

4.1.10 Economic Consequences and Burden: Another problem with the MAT is that it creates unintended adverse effects on investment. Some companies that show 'zero' or low tax liability are highly capital intensive and are able to avail of tax deductions through depreciation of machinery and goods in the initial years. These companies make high investments and are crucial to the economy and in providing employment. These companies also pay high indirect taxes like customs duty, excise and VAT. Due to the introduction of MAT, however, these companies are faced with a higher tax burden. This in turn disincentives high investment in capital goods, which is crucial for economic growth. Moreover, previously under Sec.115JA, profits derived by industrial undertakings from the business of developing, maintaining and operating any infrastructure facility covered by Sec.80-IA, was exempted from computing book profits. Under the current Sec.115JB, however, this exemption has been removed. Further, companies with low depreciation (like finance companies) but who are making consistent losses will have to pay MAT despite heavy carry forward losses. Companies with high depreciation will be liable for MAT in the year in which there is net profit after depreciation irrespective of the fact of heavy unabsorbed depreciation. 49C.

4.1.11 Other difficulties: The co-existence of deemed total income (book profits under the Companies Act) along with the statutory income calculated under the ITA, has itself been a source of confusion for the assesses and the revenue authorities. One such example is with respect to Sec.80HHC. Sec.80HHC provides for the deduction of an amount equivalent to 80 percent of the 'eligible profits' from the exports, from the gross total income. Under Sec.115JB, however, one of the deductions that could be made from the book profit was on the 'eligible profit from exports' as computed under Sec.80HHC(3)(a)/(b)/(c) and under Sec.80HHC(3A). The dispute that arose was with respect to the position taken by the revenue authorities, whereby they claimed that the amount deductible under Sec.80HHC from the gross income, should also be the amount that can be deducted from the book profit (as opposed to the deduction of 'eligible profit' from the book profits). The dispute was, however, settled by the Supreme Court in *Ajanta Pharma Ltd v. CIT*,[63] whereby it made a distinction between the computation of 'eligible profits' that could be deducted from the book profits and the 'amount of deduction allowed' under Sec.80HHC (which is a certain percentage of the eligible profits) for the purpose of the gross total income.[64]

4.1.12 Suggestions: As shown above, the MAT regime has raised significant problems in terms of the burden of tax and the difficulties in compliance and recordkeeping. Companies are required to maintain two sets of accounts and submit them periodically in order to pay advance tax. It is a basic canon of taxation law that procedure of taxation must be certain and clear.[63] The present MAT regime falls short in this regard. Further, in some cases, the MAT is an excessive burden on companies. Moreover, the provisions of the proposed DTC also eliminate a number of exemptions, deductions and incentives, which are available under the ITA. Unfortunately, MAT has emerged as an imperfect solution to an imperfect system of unmanaged tax deductions. In order to address the problems of the present complex and irrational corporate taxation regime (MAT), I propose two solutions. The first is to abolish MAT and reduce the tax incentives and make the depreciation provisions (depreciation rate) in the ITA or DTC at par with the Companies Act and to continue with the ITA or DTC as the case may be. The second is to have a separate legislation for corporate taxation based solely on book profits. Certain incentives can, however, be provided to certain particular sectors if the State desires. These two proposals are explored in further detail below. The problem of 'zero-tax' companies is a result of the reduction in the tax base of certain companies because of exemptions, deductions and allowing high rates of depreciation for certain industries. One way to address this problem is to increase the tax base of companies so that their taxable income increases. The high rate of depreciation under the ITA, for instance, is a significant cause for the reduction of tax base. Depreciation can be claimed by any company irrespective of its output or location, and hence, covers a greater number of companies than Special Economic Zones, tax holidays or export promotion measures. The rate of deprecation under the ITA is much higher than the rate of depreciation that can be claimed under the Companies Act. The tax base can be significantly increased if the rate of depreciation is brought on par with that in the Companies Act. In addition, the number and extent of deductions and exemptions given to companies should be reduced. The Kelkar Committee has also recognized this as a problem, and has suggested that the MAT regime be abolished and the procedure for taxation be simplified by a reduction in the exemptions and deductions granted to companies.[63] Similar arguments for reform have been made in the American AMT system. These changes will result in an increased tax base and a reduction in the amount of exemptions that companies may avail of and thus, address the problem of zero-tax companies without resorting to a MAT system.

As discussed above, one of the main difficulties with MAT is the maintenance of two different sets of accounts for determining taxable income. These two accounts, moreover, must be submitted periodically for the payment of advance tax as well as at the time of filing final income tax return. Thus, the corporate taxation regime has become much more complicated and irrational. The corporate taxation regime can be simplified and made more rational, either by eliminating MAT and simplifying the existing ITA with less deductions, incentives and with broad tax base or to scrap the ITA, as is applicable to companies, and to have separate legislation for corporate taxation based only on book profits. This would have the advantage of reducing the confusion and cost of compliance with MAT and further, streamline the regime of corporate taxation and bring about convergence of these two systems. The regime can, however, be modified to allow certain tax incentives in the form of deductions, exemptions in order to promote a particular sector of an industry or backward region. This would have the advantage of being a simpler and more transparent procedure for corporate taxation. In conclusion, considering the inflow of foreign direct investment in India and the growth of domestic companies, both in size and revenue, it would be more efficient to have a separate legislation on corporate taxation based on book profits. If, however, there is any need to promote a particular sector of industry or a backward region, additional negative adjustment may be provided while calculating book profit.

4.2 Securities Transaction tax: Capital has become highly mobile across international markets during the last three decades. This has virtually forced policy-makers to reorient their tax policies, particularly with respect to capital gains tax. In order to encourage inflow of foreign capital, many countries have either reduced or abolished capital gains tax. Several countries have considered a small dose of a Securities Transaction Tax (STT) either as a substitute for capital gains tax or as an independent tax. Both the taxes are not strictly comparable. While capital gains tax is based on certain canons of taxation, STT is essentially a turnover tax. In addition to revenue consideration, at least one thing is common between these taxes for both discourage short-term speculative activities. At present, India has a system of capital gains tax. As per the existing provisions of the Income Tax Act, any profit or gain arising from the transfer of capital assets is chargeable to income tax under the head of capital gains. A capital asset is distinguished on the basis of the holding period. A capital asset, which is held for more than three years, is categorized as a long-term asset. However, a capital asset in the nature of securities is categorized as a long-term one if it is held for more than one year. Gains on the sale of capital assets held for more than three years are treated as long-term capital gains. In case of listed securities/ mutual fund units, gains on the sale of capital assets held for one year or more are treated as long-term capital gains. Thus, short-term capital gains tax is applicable to gains from assets held for less than one year in the case of listed securities/mutual fund units and for less than three years in the case of other assets. Long-term capital gains are subjected to a concessional tax rate of 20 per cent. If the long-term capital asset is in the nature of listed securities (equity) or units, the rate of tax on such assets was 10 per cent of gains computed without inflation indexation, or 20 per cent of gains computed after indexation, whichever is lower. However, since 2003-04, there is no long-term capital gains tax if the asset is in the nature of listed securities (equities) or units. In respect of short-term capital gains, the concessional tax treatment is not allowed. The short-term gain is aggregated with the total income of the tax payer and is taxed at the overall tax rate applicable to the assessee. Thus, short-term capital gains are taxed at the rate of 20 per cent or 30 per cent depending on the respective income slab of an assessee. At present, there is no distinction between residents and non-residents so far as long-term capital gains tax is concerned. However, the union budget 2003-04 exempted long-term capital gains tax for one year on the income from sale of equities held for more than 12 months, and purchased on or after March 31, 2003. The interim budget for 2004-05 proposed to extend this exemption for a period of three years. In the regular budget for 2004-05, long-term capital gains tax was abolished and the short-term capital gains tax was reduced from a maximum of 30 per cent to a flat rate of 10 per cent. Moreover, as a part of the package, securities transaction tax (STT) was introduced for the first time in India which has become effective from October 1, 2004.

a) The STT of 0.15 per cent would be shared equally by the buyers and sellers of equities, and units of equity-oriented funds for all delivery-based transactions (trade-for-trade settlement mode) entered into in a recognized stock exchange.

b) For day traders and arbitrageurs, the STT of 0.015 per cent would be imposed on sellers of equities and units of equity-oriented funds settled on a net basis (netted settlement mode). They can set off STT against tax on business income.
c) The rate of STT on the sale of derivatives would be 0.01 per cent.
d) Debt instruments are completely exempted from STT.
e) Education cess of 2 per cent would not be imposed on STT.
f) As per the provisions of the Finance Act, 2004, stock exchanges/ mutual funds have been entrusted with the responsibility of levy, collection and remittance of STT on all transactions from October 1, 2004 on a daily basis

In brief, while short-term capital gains have been taxed at the same rate as personal income tax (20 to 30 per cent) depending on the respective income slab of the assessee, long-term capital gains have been exempted from any such tax for listed securities purchased on or after March 31, 2003 and held for more than 12 months. For the purpose of levying capital gains tax, both FIIs and domestic investors are treated alike. However, FIIs that have entered the domestic market through countries with whom India has a Double Taxation Avoidance Treaty (DTAT) such as Mauritius, Spain, Cyprus and UAE, avoid paying any short-term capital gains tax due to exemption available under the DTAT. This is an anomaly leading to discrimination among FIIs. While one set of FIIs have been getting exemption, the remaining have been paying short-term capital gains tax. More- over, there is no level playing field between domestic investors and FIIs coming to India through the route governed by the DTAT.

4.2.1 Economic Rationale

The academic debate as regards STT owes its origin to Keynes (1936). The intuitive rationale behind his proposal was to discourage speculative transactions. The idea was developed by James Tobin (1984), Joseph Stiglitz (1989) and Summers and Summers (1989). It was argued that the financial sector of the economy absorbs too many of resources relative to the social benefit it produces. Accordingly, a securities transaction tax could raise the efficiency of financial markets by crowding out market participants who do not behave rationally or waste too many resources for speculative activities. The latter argument came to be extended into an advocacy for "sand in the wheels of international finance". The proponents of STT, by and large, offer the following rationale in favor of such a tax. These are: (a) It has a strong potential to raise revenue; (b) It can be used as an instrument to reduce stock market volatility; (c) It can improve market efficiency; and (d) It can reallocate social wealth.

4.2.1.1 Revenue Effect

One of the fundamental motivations for levying STT is to increase tax revenues. With the rise in the volume of stock market transactions, a small STT has a significant potential to raise revenue. The amount of revenue expected to be raised from STT depends on three parameters: (a) the tax rate, (b) the volume of transactions, and (c) the average price level. An increase in STT may actually depress the volume of transactions. In addition, the prices of stocks may decline due to increased transaction costs and thereby defeat the revenue argument put forward in favor of STT. There is an influential view that a securities transaction tax reduces the prices of securities and thereby reduces tax revenue. Following a rise in transaction cost, asset prices have to fall in order to maintain a competitive rate of return. The prices of those assets that trade more frequently would decline more in order to compensate for the larger total tax bill. Liquid stock would suffer a relatively large price decline because they trade frequently

4.2.1.2 Stock Market volatility

The STT can be used as an instrument to reduce volatility in the stock market. It is widely held that considerable price volatility in stock markets emerges from the activities of the 'noise traders' who do not analyses the intrinsic value of stocks when they place orders. Therefore, such behavior may cause security prices to diverge significantly from their fundamental values. When STT is imposed transaction costs increase, which punishes noise traders for each of their short-term speculative activities and thereby reduces volatility. Haberer (2004) concludes that excess volatility is positively associated with market liquidity and it depends on the activities of noise traders. The above hypothesis was empirically tested by many researchers and the results were found to be contrary. According to them, transaction tax would influence not only noise traders, but also informed traders who play the role of price stabilizers in the stock market. Only when the tax has a greater limiting effect on the activities of noise traders, transaction tax could play a role in decreasing the volatility. Umlauf (1993), Jones and Seguin (1997), Campbell and Froot (1994) have found that an increase in trans- action costs through STT leads to a reduction in market volume (liquidity) and increase in volatility. The debate was pursued further to study whether there is always a negative relationship between volume of transaction (liquidity) and volatility. The imposition of STT generates two types of effects, namely, volume effect and structural effect. The level of tax that improves market microstructure reduces volatility as well. It has been shown that the STT discriminates against short-term investments and thereby improves market microstructure as noise traders may be more severely affected than the fundamentalist. It has also been pointed out that that with a small STT, volatility can be reduced in a highly speculative market, but in an illiquid market the STT might raise volatility.

4.2.1.2 Market Efficiency: In case of an efficient and frictionless market, asset prices reflect all available information. Investors rebalance their asset portfolios as soon as they receive new information. The rebalancing of assets results in constant updating of prices and contributes to price discovery. In the absence of STT, the re- balancing can be done continuously and price discrepancies are eliminated instantaneously. The presence of even a small trans- action tax makes continuous rebalancing expensive. Therefore, valuable information can be held back from being incorporated into prices. As a result, prices can deviate from their full information values. Moreover, transaction cost affects the volume of trade as discussed earlier. Volume plays a crucial role in the process by which market becomes efficient. According to Habermeier and Kirilenko (2003) and Hubbard (1994), migration of trade volume results in lower information efficiency of instruments. Lower asset prices following imposition of STT has a macro- economic implication too: The fall in asset prices implies a rise in cost of capital. This may hamper the capacity creation which could have been possible through fresh investment [Hubbard 2004]. Empirically, it has been tested that the correlation between stock prices and primary issues is positive.

4.2.1.3 Reallocation of Wealth

The STT is often considered a conduit through which the government taxes wealthy stock holders and reallocates social wealth in a fair and just manner. As the revenue argument is often defeated due to the volume and price effects of STT, the reallocation of wealth argument may not be robust. Moreover, the government has not been generally adjudged as the best allocator of resources. It is an efficient market that can allocate resources in an efficient manner. If investors cannot carry out their desired trades, their latent demands are not fully satisfied and resources are not allocated to their best us. The STT is often considered a conduit through which the government taxes wealthy stock holders and reallocates social wealth in a fair and just manner. As the revenue argument is often defeated due to the volume and price effects of STT, the reallocation of wealth argument may not be robust. Moreover, the government has not been generally adjudged as the best allocator of resources. It is an efficient market that can allocate resources in an efficient manner. If investors cannot carry out their desired trades, their latent demands are not fully satisfied and resources are not allocated to their best use

4.2.2 STT in India: In the union budget for 2004-05, the finance minister, for the first time in India, proposed to impose a securities transaction tax at the rate of 0.15 per cent on buyers of securities traded in the stock exchanges. According to the original proposal, the STT was applicable to G-sec and derivative instruments if traded in the stock exchanges. The STT was proposed to be levied on buyers while short-term capital gains would continue to be imposed on sellers at a flat rate of 10 per cent, as against a maximum of 30 per cent earlier. Both domestic and overseas investors would be treated alike for the purpose of STT. There were sharp reactions from participants of the stock market immediately following the budget proposal. There was considerable post-budget debate in the press as well about the uniform STT in India. It was not clear whether debt transactions traded outside the stock exchanges would attract STT. It was argued that debt transactions through the negotiated dealing system (NDS) are essentially off-market transactions which may not attract STT. Nevertheless, the debt market reacted sharply to the budget proposal on STT. The volume in the debt market fell dramatically in the post- budget period. The average size of transactions in the debt market and derivative markets are generally large and the buy-sale margin is very thin. Equal treatment of debt, equity, and derivatives for the purpose of levying STT was considered detrimental to the growth of the debt and derivative segments. In the light of international experience, the original proposal was revised. While debt securities were completely exempted from STT, it was reduced from 0.15 per cent to 0.01 per cent for derivatives. Originally a buyer of securities was required to pay STT of 0.15 per cent. He had to pay the short-term capital gains tax of 10 per cent, if he gained from the sale of the security within a year. This was interpreted by the market participants as double taxation. Finally, the French model was adopted. But, the pro- posed STT was to be shared equally by the buyer and seller of the securities at the rate of 0.075 per cent each for all delivery- based transactions (trade-for-trade settlement mode). In India, the 'day traders' account for about 70 per cent of the transactions, which provide market liquidity as well as depth to the stock market. As Indian stock markets are not highly liquid, the volume of transactions undertaken by day traders is crucial. The reduction of volume due to STT was not only perceived to affect the process of price discovery, but also believed to erode the revenue base. In view of this, the original proposal was revised so that STT would be imposed on delivery based transactions only. Day traders and arbitrageurs have been allowed to pay STT at a nominal rate of 0.015 per cent on net basis (netted settlement mode). They are also allowed to set off STT against the tax on business income. Therefore, day traders and arbitrageurs would effectively pay very little STT.

4.2.3 Conclusion

As of now, one can argue in favor of STT based on revenue considerations. But, the revenue potential of the revised STT under the present arrangement is very small and therefore it needs reconsideration. There is undue apprehension that uniform STT on day traders and other investors may reduce the volume of transactions dramatically. Of late, the Indian stock market has acquired reasonable strength. As a leading emerging market economy, India's strength ultimately lies in its fundamentals, not on the volume of transactions undertaken by noise traders. In fact, India's stock markets appear to have been a favored destination for many FIIs during recent years. In this context, what may probably be important is a competitive STT rate in India vis-a-vis in other emerging market economies, rather than a differential STT among the participants in equity trading. The illustrative rates suggested above, at 0.05 per cent uniform STT on all equity transactions and 0.01 per cent STT on derivative transactions, are not only competitive in the region but also more revenue yielding for the government. Moreover, a unified STT on all equity transactions has several other advantages like discouraging insider trading, simplifying the collection procedure, providing a level playing field to all participants, etc. A review of double taxation avoidance treaties is a complex process which has a political dimension too. It may not be easy to remove them from bilateral arrangements. At the same time, the existence of short-term capital gains tax does not provide a level playing field to domestic investors and to FIIs coming from countries with which India does not have a DTAD. The best way to cope with their dilemma is to remove the capital gains tax altogether from all securities transactions. This is consistent with the overall trend in emerging market economies, where STT is imposed on security transactions without any short- term capital gains tax. Given the low revenue potential of short- term capital gains tax in India and also the provision to set off capital gains tax against business income, its complete abolition from security transactions is a better option.

4.3 Dividend Distribution Tax

Chapter XII-D, consisting of Sec. 115-0 to 115-Q, inserted by the Finance Act, 1997 with effect from June 1, 1997, has brought about a radical change m the system of taxation of dividends. The earlier scheme of taxation was often criticized on the ground that it amounted to double taxation, once in the hands of the company and again in the hands of the shareholders. The new scheme provides that once a domestic company is chargeable in respect of the profits distributed by it to its shareholders, the dividends received by the shareholders of such a company would be exempt[36].

The tax on distributed profits is an additional tax over and above the income tax payable on chargeable profits of the company and would be payable even in cases where a company does not have to pay tax on the income as computed in accordance with the provisions of the Act. The additional tax under s 115-0 is to be paid by the domestic company within 14 days from the date of the:

(a) declaration of dividend, or

(b) distribution of dividend, or

(c) payment of dividend, whichever is earlier.

The additional tax will be treated as final payment of the tax in respect of the profits distributed and no further credit of tax shall be allowed either to a company or its shareholder in respect of the amount on which the tax has been charged. Failure to pay the

[36] Section 10(33) and 10(34) of Income Tax Act,1961

additional tax will attract penal interest at the rate of 1.25 per cent, and the company or its principal officer shall be deemed to be an assessee in default.

The levy of tax under this section was not applicable to dividends distributed between 1 April 2002 and 31 March 2003, consequent to the amendments made by the Finance Act 2002, but has been revived by the Finance Act 2003, with effect from 1 April 2003. Such additional income tax constitutes "tax on income" for the purposes of s 115J and other provisions dealing with book profit[37].

A single judge upheld the validity of s 115-0 and held that the additional tax is payable on the entire income of tea companies. On appeal, the Division Bench held that the additional tax is payable only on the non-agricultural income. Under Rule 8 of the Income-tax Rules, 1962, 60 percent of a tea company is treated as agricultural income and only 40 per cent is subject to income tax. Therefore, the additional tax under s 115-0 has to be paid only on 40 per cent of the total income of the tea company.[38]

The sub-section (1) starts with a non-obstante clause. The new scheme of provision provides that once a domestic company is chargeable to tax in respect of profit distributed by it to its shareholders, dividend received by the shareholders of such company would be exempt under sec 10(33) and 10(34). However, Sec 14A inserted by the Finance Act 2001, with retrospective effect from April 1, 1962, provides that no deduction is allowed in respect of the expenditure incurred in relation to any income which does not form part of the total income. It appears that after the introduction of Sec 10(33) and 115-O any expense incurred for the purpose of acquiring shares on which the dividend income has been earned would not be allowable as a deduction. It is important to note that the exemption prescribed in Sec 10(33) and 10(34) does not apply to deemed dividend. The Explanation to sec 115Q provides that dividend, "*for the purposes of this Chapter*" shall have the meaning given to Sec 2(22) but shall not include 2(22) (e). In a case where the majority shares of the company were held by non-residents, non-declaration of dividend and accumulating the same as reserves after coming into force of s 115-0 despite there being considerable profits, was

[37] *DCIT v. Dhanlakshmi Paper Mills Ltd* 290 ITR 27
[38] Jayashree Tea and Industries Ltd. v. UOI 285 ITR 506

held to be device to avoid tax[39] Under the India-Mauritius DT AA, there is no capital gains at the time of buy back Therefore, a company can either declare dividends which will result in the liability to pay tax under s 115-0 or the surplus funds can be utilized to buy back shares. When two options are legitimately open to the assessee, it can choose any of them. Therefore, it cannot be stated that using the funds to buy- back shares instead of declaring dividend amounts to avoidance of tax. The very purpose for exempting capital gains tax in the treaty will be defeated if such an erroneous view is adopted. There is no rule that an assessee who seeks to reduce the tax liability always indulges in a device to avoid tax. This option is now closed with the insertion of 115QA. It is also submitted that the third proviso to s 245R (2) is indeed unfortunate. If a multinational corporation has the right to take the benefit of a treaty provision which will reduce the tax burden, it should not be a ground to disallow the application. The very purpose of obtaining an Advance Ruling is lost when an enterprise is prevented from seeking an Advance Ruling on a transaction on that ground that it is to avoid tax. The third proviso should be restricted to devices to evade tax.

A new Chapter XII-DA, comprising of sec 115QA to 115QC, was introduced by the Finance Act, 2013 with effect from June 1, 2013. Before insertion of this chapter, a company, having distributable reserves, had two options: (i) to distribute the same to its shareholders as dividends; (ii) purchase its own shares (i.e. buy-back of shares) at a consideration fixed by it. In the first case, the payment of dividends was subject to tax under s 115-0 an income in the hands of shareholders was exempt. In the second case, the income was taxed in the hands of shareholder as capital gains. In order to avoid the tax under s 115-0, unlisted companies, as part of a tax avoidance scheme, resorted to buy-back of shares whereby the capital arising to the shareholders were not wither chargeable to tax at were taxable at a lower rate. In order to plug this loophole, these sections have been inserted wherein the consideration paid by the company for purchase of its own unlisted shares will be charged to tax and the company will be liable to pay additional income tax at the rate of 20 percent of distributed income. The additional income tax payable to the company shall be final tax similar to dividend distribution tax. The income arising to shareholders in respect of such buyback would be exempt.

[39] In Re A, 343 ITR 455 (AAR)

Chapter 5. Computation of Taxable income and liability

The following steps can be used to determine taxable income and liability under the Income tax Act, 1961 for companies:

5.1 Determining income under the different heads

The different head used are

a. Income from House property
b. Income from other sources
c. Income from capital gains
d. Profits and gains of business and profession

5.2 Inclusion of Income of other persons

Commenting on the object of corresponding legislation in England[40], Lord Mc Millan said in *Chamberlain v. IR*[41]This legislation forms part of code of increasing complexity in England beginning with Finance Act 1922, Sec 20 designed to overtake and circumvent a

[40] Part IV of the Finance Act 1938
[41] 25 TC 317; 329-30 (HL)

growing tendency on the part of taxpayers to endeavor to avoid or reduce tax liability by means of settlement. Stated quite generally the method consisted in the disposal by the taxpayer of part of his property in such a way that the income should no longer be received by him, while at the same time he retained certain powers over, or interest in the property or its income. The legislature's counter was to declare that the income of which the taxpayer had thus sought to disembarrass himself should, notwithstanding, be treated as still his income and taxed in his hand accordingly.[42] Under Sec. 60 and 61, of Act, income which arises to any person (i) by virtue of any 'transfer' [s 63(b)] from assets remaining the property of the transferor or (ii) by virtue of a revocable [s 63(a)] transfer of assets, is deemed to be the income of the transferor and taxed as his income.[43] Section 60 expressly provides that it applies to transfers though effected prior to the commencement of the Act. Even on general principles, the sections in this chapter would apply to transfers effected prior to the commencement of the Act,[44] except in the cases covered by Sec.62 (ii). Further, s 60 has no application where the income stood diverted by an overriding title as a matter of fact even before the accrual of income.[45] Similarly, s 60 cannot apply where under an agreement for the purchase of a business, the management, possession and the right to carry on the business is taken over by the assessee even before the execution of the conveyance.[46]The assignment of a part of the right to receive income from the residuary property is legal and valid, and such assignment would not be covered by s 60.[47]

.Sections 61 and 64(1) are not mutually exclusive. Section 93 contains further special provisions relating to avoidance of tax by means of transfer of assets. Where the income of the transferee under Sec. 60, 61 or 64 in the income is the income of the transferor, credit for tax deducted at source is given to the transferor and he is entitled to any refund due [48]

In the case of a gift or trust in favor of a third party, which is valid and effective in law, the transferor cannot be assessed unless the income is deemed to be his by some legal fiction.

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[42] Quoted with approval in *Tulsidas v. CIT* 42 ITR 1,4 (SC) and *Jaiswal v. CIT* 224 ITR 619 SC
[43] *Kauralal v. CIT* 26 ITR 642
[44] *Maharaj of Pithpuram v. CIT* 13 ITR 221 (PC), *Baniejee v. CIT* 9 ITR 137 (FB)
[45] *Dalmia Cement v. CIT* 237 ITR 617 (SC)
[46] *CIT v. Rungmatee* 194 ITR 282
[47] *CIT v. Contractor* 192 ITR 261
[48] Sec 238 (1) of Income Tax Act,1961

If there is no valid, effective and complete transfer of property or declaration of trust, the income would continue to remain that of the intending transferor or settlor under the general law and would be taxable in his hands apart from the provisions of Sec. 60 and 61. In a case where no registered deed of conveyance of property was executed, but the transferee was put in possession of the property, enjoyed the income and there was consideration for transfer of the property, it was held that the provisions of s 60 do not apply.[49] No question can arise of invoking Sec 60 and 61 when there is no effective transfer or trust, or when the trust is not created by the assessee.[50] In the case of a benami transaction, the beneficial owner may be assessed apart from the provisions of these sections.Scope and Effect of Sections 60 to 63.-The scope and effect of the fasciculus of Sec 60 to 63 are as follows:

(a) Transfer of Income without Transfer of Assets.-All income arising to any person by virtue of any transfer, settlement, trust, covenant, agreement or arrangement, from assets remaining the property of the person who made the transfer, settlement etc is deemed to be the income of that person and is taxable in his hands. It is immaterial whether the transfer settlement etc is revocable or not. There is no exception to this rule.

(b) Revocable Transfer of Assets.-All income arising to any person by virtue of a transfer of assets (1t may be a settlement, trust, arrangement or any other kind of transfer) is deemed to be the income of the transferor and taxed in his hands

(i) if the transfer is revocable;

(ii) if it contains any provision for the direct or indirect retransfer of the whole or any part of the income or assets to the transferor; or

(iii) if in any way it gives the transferor a right to reassume power, directly or indirectly, over the whole or any part of the income or assets. There is one case which forms an exception to the above rule embodied in s 61. That section does not apply to the case of

[49] *BE properties v. CIT* 201 ITR 810
[50] *CIT v. Sharad* 257 ITR 643, *CIT v Sathiyavathi* 225 ITR 109

income arising to any person by' virtue of a transfer where all the following conditions concur:

(i) The transfer:

(a) should be irrevocable during the lifetime of the beneficiary in the case of a trust trust or during the lifetime of the transferee in the case of any other transfer, or for a period exceeding six years provided the transfer was made before April 1,1961

(b) should not contain any provision for the direct or indirect retransfer of the whole or any part of the income or assets to the transferor during the aforesaid period[51]

(c) should not in any way give the transferor the right to reassume power directly or indirectly over the whole or any part of the income or assets during the aforesaid period[52] and

(ii) the transferor should derive no direct or indirect benefit from the income[53]·

Section 61 does not apply to income arising to any person by virtue of a transfer which fulfils all the above conditions, but the application of the section would be attracted as and when the power to revoke assets to the transferor even though the power may not be actually exercise The wording of Sec 61 and 62 1s sufficiently wide to exclude some part of the income arising under a settlement from the operation of law while the rest of the income may fall within the purview of that section[54]. Thus, income arising to one person under a settlement may be taxed as his income; while income arising to another person under the same settlement may be deemed to be the income and taxed in the hands of the settlor. In cases where by virtue of a transfer which includes under s 63(b) a settlement, trust, covenant, agreement or arrangement- income arises to any person and there is no transfer of the assets from which the income arises the income may, on general principles, be regarded as the income of the transferor and assessed m his hands, though applied in a

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[51] *Ramji v. CIT* 13 ITR 105, *CIT v Jitendar* 50 ITR 313
[52] *Subraminia v. AG* ITO 53 ITR 764
[53] *CIT v. Kikabha*i 16 ITR 207, *Subbulakshmi v. CIT* 28 ITR 561
[54] *Cf. Gullabai v. CIT* 69 ITR 238

particular manner under the legal obligation[55] This section provides that in all such cases the income should be assessed as the income of the transferor[56] thus rendering it unnecessary to decide the question whether in a given case under the general law the income is the income of the transferor or of the other person to whom it arises by virtue of the transfer. In *CIT v Sunil,*[57] the assessee created a trust by a deed of settlement assigning half of his right, title and interest as a partner in the firm. The Supreme Court drew a distinction between a case where a partner assigns his share in favor of a third person, and a case where a partner constitutes a sub-partnership, and held that in the former case there is no diversion of income by overriding title and the share of the income of the assessee assigned to the trust has to be included in the income of the transferor. The Supreme Court reiterated its earlier view in *Murlidhar Himastingka v CIT*[58]that a sub-partnership creates a superior title and results in diversion of the income from the main firm to the sub-partnership before the same becomes the income of the concerned partner, and hence, even if the partner receives the income from the main partnership he does so not on his behalf, but on behalf of the sub-partnership; thus, it is a case of transfer of the asset of the firm itself to which Sec 60 read with s 63 has no application. Retention of the property from which the income arises is an essential condition for the applicability of s 60.[59] When residential premises being used as a hostel is transferred to a charitable trust, it is the business of running the hostel that has been transferred and not merely the income from that business. Therefore, it is not hit by s 60.[60]Similarly, in a case where an assessee transferred a part of his share in the business of a partnership firm to a trust for the benefit of his children, 1t was held that the income generating apparatus had been transferred and not merely the income. It was also found that the transfer had been charged to gift-tax.

All income arising to any person by virtue of a revocable trust under section 61 as the income of the of a revocable transfer of assets is chargeable under this section as the income

[55] *Provatkumar v. CIT* 41 ITR 624 SC; *Ramachar V. CIT* 42 ITR 25 SC; *Kartar singh v. CIT* 73 ITR 438; CIT v *Thakkar* 170 ITR 224; *CIT v. Grandhi* 173 ITR 593
[56] *CIT v. Thobandas* 109 ITR 296
[57] 259 ITR 10 SC
[58] 62 ITR 323 SC
[59] *Banyan v. CIT* 222 ITR *831*
[60] *CIT v. A Radhakrishnan* 271 ITR 109

of the transferor under Sec 62(1).The word ‘revocable’ and ‘transfer’ in this section must be artificially extended meanings ascribed to then by cl (a) and (b) respectively of Sec.63.

Section 61 merely shifts the liability to tax from the beneficiary to the settlor; It does not charge income which is exempted from tax under any other provision of the Act. Therefore, in the case of a revocable charitable trust of personality created by a Parsi, the income, though deemed to be the income of the settlor, was held exempt from tax under sec. 4(3)(i) of the 1922 Act as it then stood.[61] As regards the question whether such income would still be exempt from tax under s 11 of this Act.

When Trust comes to End.-In *Behramji Lalkaka V CIT*[62] the assessee settled certain properties upon trust for the benefit of his three children. In accordance with the terms of the trust-deed, upon the death of one of the children the property set apart for him was held by the trustees absolutely in equal shares for the other two children. Held, in respect of the property so held absolutely for the two surviving children the trust had come to an end, the trustees who were in possession were merely bare trustees, and the income from the property arose to the children no longer by virtue of the trust but by reason of the fact that they had become the absolute owners of the property. Therefore, s 16(1)(c) of the 1922 Act corresponding to the present s 61 had no application, and though the trust-deed reserved to the settlor the power of revocation, the income in question could not be deemed to be his income and taxed in his hands. ·

Sec 62(1) of the Act forms an exception to the general rule laid down in s 61 that in the case of a 'transfer' of assets which is 'revocable' within the meaning of those terms in s 63, the transferor is chargeable in respect of the income. Even though a settlement may be 'revocable' within the extended meaning given to that word ins 63(a), s 61 would still not apply to it if the conditions laid down in s 62 are fulfilled.[63]Conversely, the fact that a settlement is not revocable in the ordinary sense of the word during the lifetime of the beneficiary, is not sufficient to satisfy s 62; the settlement should not be revocable within

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[61] *CIT v. Navaji* 16 ITR 109

[62] 16 ITR 301

[63] *CIT v Bhuwaneshwari* 53 ITR 195 (SC), approving *Ramji v CIT* 13 ITR 105, *CIT v Jitendar* 50 ITR 313, 320-32, *Kohiyar v CIT* 51 ITR 221

63(a) for the period specified in 62[64]. This section provides an exception only to s 61 and not to s 60. Therefore, if there is a transfer of income but no transfer of the assets from which the income arises, the transferor would be chargeable under s 60 even though the transfer may be irrevocable during the lifetime of the transferee and the transferor may derive no direct or indirect benefit from the income. The corresponding provisions were different under the 1922 Act.[65] ·

Under the 1922 Act, the settlor was not charged if the settlement was irrevocable for a period exceeding six years. This section renders the settlor chargeable in cases of such settlements made after March 31, 1961. But the old rule continues and the settlor is not taxed in cases of 'transfer ... made before the April 1, 1961'. A transfer is made when the property to settled· upon trust and not when a trust, irrevocable for a specified period, is made irrevocable for a. further period. Therefore, if the original settlement, irrevocable for a· period exceeding, was made before April 1, 1961; this section would apply even though after that date•· the settlement is made irrevocable for a further period exceeding six years. If the terms of a settlement are such that the settlement may be revoked during the lifetime of beneficiary, a supplemental deed to rectify this would not have retrospective effect in respect of income which passes prior to the supplemental deed, the benefit of this section cannot be claimed[66]. If a settlement made before April 1, 1961 is irrevocable for a period exceeding six years and the period of irrevocability is extended for a further period of three years by a supplemental deed executed just a few days before the original deed is about to become revocable, this section would not be satisfied as regards the income of the further period of three years. Because the relevant settlement in force during that period would be the original settlement coupled with the supplemental deed and at settlement, that settlement would be irrevocable for a period of less than six years.[67] In applying this section and determining whether the settlement is revocable for the requisite period, regard must be had to the effect of the settlement in the light of the circumstances actually existing in each year of assessment. - ·

[64] *Manic sagam v. CIT* 53 ITR 292
[65] *Shahpure v CIT* 14 ITR 781
[66] *Taylor v. IR* 27 TC 93 CA
[67] *IR v. Nicolson* 34 TC 354

Even if a trust is irrevocable for the prescribed period, s 62 would not apply and the trust would fall within the ambit of s 61 if the settler derives a direct or indirect benefit from the income of the trust. However, as the Supreme Court laid down in *CIT v Bhuwaneshwari Kuer*,[68] the direct or indirect benefit should be from that income which is paid to others and which is sought to be charged in the settlors hand under s 61. It was held in that case that if the settlor receives part of the trust income as a beneficiary but receives no direct or indirect benefit from the balance of the income paid other beneficiaries and the trust is irrevocable for the period specified in s 62, the income paid to the other beneficiaries cannot be included in the settlor's total income. The ratio of the Supreme Court's judgment is that even if a trust is revocable within s 63(a) in that it contains a provision for the re-transfer of a part of the trust income or assets to the transferor of the part of trust income, still apply in respect of another part of the trust income which arises to another beneficiary. In other words, Sec 62 looks distributively at various trusts created by a single settlement and if the trust in favor of a particular beneficiary is irrevocable-in the ordinary sense and in the artificial sense of s 63(a)-for the period specified in Sec 62 and the settlor derives no direct or indirect benefit from the income arising to that beneficiary, s 62 would save such income from being assessed in the hands of the settlor. *Bhuwaneshwari Kuer* was under the 1922, Act and it was followed by the Supreme Court in *Hrishikesh Ganguly v CIT*[69], which was also under the 1922 Act. In the last mentioned case the Supreme Court made obiter[70] observations suggesting, that the position might be different under the 1961 Act in which s 63(a) deems a transfer tot revocable if it contains any provision for the retransfer of 'the whole or any part' of the trust income to the transferor, whereas these additional words were not there, in the corresponding provision of the 1922 Act. This obiter is erroneous. It overlooks the correct ratio (set out above) of *Bhuwaneshwari Kuer* which is not affected in any manner by the words added in Sec 63(a). Again, it overlooks that in *Bhuwaneshwari Kuer* the Supreme Court's judgment proceeded on the footing that the settlement was revocable within the provision of the 1922 Act corresponding to s 63(a) and the court still held that the settlor was entitled to the benefit of the provision corresponding to the presents

[68] 53 ITR 195,201-02

[69] 82 ITR 160

[70] Followed in *Chunnila v CIT* 139 ITR 166

62.Thus, the decision would have been the same if the 1922 Act had expressly referred, like s 63(a), to 'the whole or any part' of the trust income. Further, the proviso to s 62(1), like the corresponding provision of the 1922 Act requires· that the transferor should derive 'no direct or indirect benefit from such income i.e. the· particular beneficiary's income which is sought to be assessed in the hands of the settlor, Any benefit derived .by the transferor from any other part of the trust income is irrelevant for the purpose of s 62. On this point, there is no difference between the wording of s 62 and that of the corresponding provision of the 1922 Act.

In *CIT* v *Kikabhai Premchand*[71]the assessee created a trust irrevocable for a period exceeding six years but under the terms of the· trust of which he was one of the trustees. He reserved to himself the power to make loans to any ·person, including himself, without security. Held, this power amounted to denying indirect benefit from the income of the trust and therefore, the income of the trust 'should be deemed to be the income of the settlor and included in his total income. That the settlor had in fact made no loan to himself out of the trust moneys and therefore, derived no benefit in fact from the income of the trust was held to be irrelevant; and the crucial question was held to be whether the terms of the trust-deed enabled the Settlor to derive any direct or indirect benefit for himself from the income of the trust.[72]But, if the trustees (even if they are themselves the settlors), under a general power to make loans, advance moneys on normal commercial terms to a company in which the settlors have some interest, it cannot be said that the settlors derive an indirect benefit from-the trust.[73]

If the trust of the corpus is irrevocable, s 62 would have no application at all ·and the· question of 'direct or indirect benefit' would be irrelevant. In such a case, the department can succeed in applying s 61 only if it can bring the case under s 63(a)[74] . If the benefit received by the assessee is illusory or so slight as to be considered negligible e.g. where a trust-deed contains a provision· for applying a small-portion of the income of the trust in a

[71] 16 ITR 207
[72] *Glyn v IR* 30 TC 321
[73] *Manicavasagan v. CIT* 53 ITR 292, *CF CIT v. Jayantilal* 67 ITR SC(1*) CIT v Gopalakrishnaan* 57 ITR 569
[74] *CIT v Raghbir* 57 ITR 408 (SC); *Abhay v CIT* 31 ITR 861

specified contingency for the maintenance of a family of which the settlor is a member-it would not amount to any 'direct or indirect benefit' within the proviso to s 62(1), and the case would be taken out of the operation of s 61 if the other condition laid down in s 62, viz irrevocability during the prescribed period, is fulfilled.[75] 'The characteristic of a benefit is that it is real and not notional, concrete and not abstract, certain and not conjectural. For the purposes of clause 63(a), a transfer, settlement etc is 'revocable notwithstanding that the power of revocation is not absolute or unqualified. For example, even if a transfer can be revocable only with the consent of any named person or persons, it would never the less be revocable[76] Likewise an out and out sale which provides for retransfer to the vendor in certain contingencies would still be revocable within the meaning of this clause." [77] Again it is not necessary hat the power of revocation should be exercisable by the settlor himself. A trust which is irrevocable at the settlor's instance, but can be revoked by the trustees is a revocable trust. A limited power of revocation enabling the settlor to appoint new, beneficiaries would· also make the settlement revocable within this clause.[78]

5.3 Adjustment of Current and brought forward losses
: Current and brought forward losses are adjusted according to provisions of Sec 70 to 80. It has been noted under Sec 14 which classifies income under sox heads that income tax is only one tax levied on the sum total of the income classifies under various heads and that it is not a collection of distinct taxes levied on each head of income. One of the important co0nsequences which follow from the principle that income tax is only one tax and there are heads of income, is that a loss sustained in any year under one head should be set off against income under another head in that year, in order to arrive at the true total income of the assessee[79]

5.3.1 Set off of Loss against Income under same head.
-Except in the four cases noted below, if the net result in respect of any source under any head is a loss that loss may be set off under section 70 against income from another source under the same head. Income under each head is computed by adding together the incomes from various sources which

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[75] *SaraswatibaiBhaidas v CIT* Unreported Bombay
[76] *Jyotendrasinjhi v Tripathi* 201 ITR 611 SC, *Behrmji v CIT* 16 ITR 301, Glyn v IR 30 TC 321
[77] *Tarunenedra v CIT* 33 ITR 492
[78] *Keshavala v CIT* 12 ITR185; *Subramania v AG* ITO 53 ITR 764
[79] *Anglo French textile v CIT* 29 ITR 82 SC

fall under the same head. There was no such express provision in the 1922 Act for setting off losses against income under the same head" but the principle was held to be implicit in that Act. For instance, losses in a business were set off against profits in another business or against professional earnings under the old s 10 itself which corresponded to s 28 of this Act.[80] The loss in one business may be set off against the profits of the same year in another business." even though the business in which the loss was incurred may have been carried on only for a brief period in the accounting year and discontinued within such year.[81]However, where the assessee cannot show that the business was being carried on in India during the relevant assessment year, no set-off can be claimed[82]."

There are four exceptions to the rule that a loss can be set off against any other income under the same head:

(i) A loss in a speculation business[83] can be set off only against the profits of another speculation business.

(ii) A loss incurred in the activity of owning, and maintaining race horses cannot be set off against income from any other source[84].

(iii) A loss incurred in any gambling activity cannot be set off at all against any other income, not even against income from another gambling activity, .i.e. the same source [s 58(4).] However, prior to the assessment year 1987-88 a loss in a gambling activity could be set off against income from another gambling activity falling within the same source, but not against income from any other source

(iv) A long-term capital loss can be set off only against a long-term capital gain[85].

Prior to the assessment year 1988-89, a long term capital loss could be set off only against a long-term capital gain[86]. This restriction was removed for assessment years 1989-90 to

[80] *CIT v CP Syndicate* 11 ITR 493
[81] *Re Hulasilal* 9 ITR 635
[82] *CIT v Froamer France* 317 ITR 18, (2009) 226 CTR (Utt) 79
[83] explanation 2 to section 28, s 43(5) and explanation to s 73 of of the Income Tax Act,1961
[84] s 74A(3) of Income Tax Act, 1961
[85] s 70 of Income Tax Act, 1961, as amended by the Finance Act, 2002 with effect from April 1, 2003
[86] deleted s 70(2)(u)

2002-2003. Sections 70 and 71 contemplate loss from a source the income from which is liable to tax. According to the Madras High Court, if income from particular source is together exempt from tax loss from that source cannot be set off against income from a different source or income under a different head.[87]The Calcutta High Court has taken the contrary view.[88]

5.3.2 Set off of Loss against Income under another Head

-: If after setting off losses against income under the same head the net result is still a loss, such loss may be set off under s 71 against income of the same year under any other head for losses which arise under the head capital gains[89]For instance, loss in business may be set off against income from property, and loss under the head income from other sources' may be set off against profits of business.[90]Business loss determined is eligible for set-off against income determined under undisclosed sources.[91] Loss relating· to house property can similarly be set off against income under other heads.[92] In *CIT v British Insulated Calendar Ltd*, [93] the Mumbai High Court held that the assessee had no option to carry forward business loss where there was income from other sources, and therefore, business loss had to be set off against dividend income of the same year. The exceptions to this rule are loss in speculation business, loss in owning and maintaining race horses, loss in gambling activities and capital losses which cannot be set off against income falling under any other head[94] Losses under the head 'Capital gains' are dealt with by s 74, . For the assessment years 1993- 94 and 1994--95, losses under the head 'Income from house property', other than the loss in respect of self-occupied properties[95] were not allowed to be set off against any other head of income[96] Sub-section (4) was substituted by the Finance Act, 1994 with effect from April 1, 1995 to remove the restriction on the set off of loss, and to provide for a priority for the

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[87] *Ramjilal v CIT* 58 ITR 181 *CIT v Thiaga rajan* 129 ITR 115
[88] *Royal Calcutta Turf Club v CIT 1*44 ITR 709
[89] Sec. 71 of Income Tax Act, 1961 as amended by Finance (No 2) Act, 1991, with effect from April 1, 1992.
[90] *Varier v CIT* 8 ITR 628
[91] *CIT v Chensing Ventures* 291 ITR 258, (2007) 212 CTR (Mad) 539
[92] *CIT v Ram Prasad* 205 ITR 622, *CIT v Goverdhan* 205 ITR 751
[93] 202 ITR 354, *CIT v Milling Trading* 211 ITR 690
[94] Sec 58(4), 73 and 74A of Income Tax Act, 1961
[95] Sec 23(2)(a)(i) of Income Tax Act, 1961
[96] Sec 71(4) of Income Tax Act, 1961

current loss under income from house property over the losses carried forward in terms of the provisions of s 71A for the assessment years 1993-94 and 1994-95. Section 71 has been amended by insertion of sub-s 2A with effect from 1-4-2005, prohibiting the set off of loss arising from business or profession against the income assessable under the head 'salary'.

In as much as the assessee has an option under s 71, short-term capital loss can be set off against income from other heads.[97] A conjoint reading of sec. 70(2)(i) [now sec 70(3)] and 71(3) implies that where the assessee has a short-term capital loss, he must first set it off against any capital gains long-term or short-term-before setting it off against income from any other head.[98] The assessee is entitled under this section to set off his loss against the income of his spouse or minor child included in his total income under s 64. An assessee incurred a loss on destruction of its goods in a warehouse. A suit for recovery of this loss was dismissed in a later assessment year. The loss could be claimed in the later assessment year since the assessee had not accounted it as a loss until that year.[99]Section 71B provides that if the loss under Income from House Property cannot be set off against any other head of income then the same can be forward to set off against the income under that head for the subsequent eight assessment years. Carry forward of Loss is distinguished from unabsorbed depreciation[100]. If the loss cannot be set off under Sec 71 because of the absence or inadequacy of income under any head it may under Sec 72 be carried forward and set off against the profits of subsequent year. Some of the items that can be carried forward are as follows:

1. Unabsorbed deprecation [Sec32(2)]
2. Unabsorbed Investment allowance [32A (3)(ii)]
3. unabsorbed development rebate [s 33(2)(ii)],
4. unabsorbed development allowance [s 33A(2)(ii)],
5. unabsorbed capital expenditure on scientific research [s 35(4)],
6. expenditure on prospecting for certain minerals [s 35E(4)],
7. expenditure for promoting family planning [s 36(1)(ix)], (viii)

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[97] *CIT v Mahendra Kanaiyalal* 202 ITR 701
[98] *CIT v mahendra and Co* Ltd 269 ITR 12, 2004 190 CTR Raj 86
[99] *New Dewan Oil Mills v CIT* 328 ITR 432
[100] Section 72 of Income Tax Act, 1961

8. losses in speculation business (s 73) and losses in business other than speculation (s 72),
9. losses under the head 'Capital gains' (s 74),
10. losses in the activity of owning and maintaining race horses [s 74A(3)], and

The carry forward of unabsorbed depreciation, other than pre-1988 balancing allowance, investment allowance, development rebate, development allowance and capital expenditure on scientific research, is not governed or covered by s 72 at all, and its incidents are different from those of the carry forward of business loss under s 72.

5.3.3 Conditions governing Carry Forward of Business Loss

.-The right of carry forward of loss under s 72 is subject to the following restrictions and conditions: ·

(i) The loss should be in a business, profession or vocation[101]

(ii) It should not be sustained in a speculation business. Losses in speculation business are separately dealt with by s 73.

(iii)The· loss may be carried ·forward and set off against the profits and gains in a subsequent year, of any business, profession or vocation and not necessarily the same business, profession or ·vocation as that in which the loss was incurred[102] In no case can a loss carried forward under this section be set off against the· profits from a source other than business, profession or vocation.

(iv) The business, profession or vocation in which the loss was originally sustained .should continue to be carried on by the assessee in the year in which the carried forward loss is sought to be set off The exception to this rule is the case dealt with by s 41(5).

(vi) The loss can be carried forward and set off only against the profits of the assessee who incurred the loss. In other words, the person who incurred the loss alone has the right to carry forward the same and· the successor in business cannot claim to carry forward the loss incurred by his predecessor in business. There are two exceptions to this principle.

[101] *CIT v Manmohan* 59 ITR 669 SC
[102] Sec 72(l)(i) of Income Tax Act, 1961

One is the case of succession by inheritance[103] The other exception is provided by s 72A. On fulfillment of the conditions set out in that section, the accumulated loss of a company can even after amalgamation or demerger be carried forward by the successor company. But apart from s 72A, under the general law the past losses of a company which merges into another under scheme of amalgamation cannot be carried forward by the successor company. Similarly the losses suffered by four co-operative societies, for instance cannot be claimed by the co-operative society formed by their merger, since the resulting society is a separate assessee[104].

(vi) A loss cannot be carried forward for more than eight years,[105] even if there was no assessment in one year in between due to a change in the previous year.[106]

(vii) A loss cannot be carried forward unless it has been determined in pursuance of a return filed under s 139. In order to be entitled to carry forward a loss, the asses see must submit a return under s 139(3), and have an assessment made for the year in which he has incurred the loss[107]. The assessing officer has to notify to the assessee by an order in writing the amount of the loss as computed by him which the assessee is entitled to have carried forward[108]. In the case of a business which is discontinued by reason of any of the calamities mentioned in s 33B and is subsequently re-established, reconstructed or revived within three years, there is a relaxation of the rules that the business in which the loss was originally sustained should continue to be· carried on and that a loss cannot be carried forward for more than eight years[109]

5.3.4 Set off and carry forward of loss under the head 'Capital Gains': The finance Act 2002 has distinguished between short term losses and long term losses and now provides with effect from April 1,2003 as follows:

[103] Sec 78(2)of Income Tax Act, 1961; *Saroj v CIT* ITR 497 SC
[104] *Rajasthan rajya Sehkari Spining and Giinng Mills federation ltd v ITAT* 260 ITR 167
[105] *Reliance v CIT* 120 ITR 921 SC
[106] Sec 72(3) of Income Tax Act, 1961. ; *CIT v Covelong Beach Hotels India Ltd* 262 ITR 544; (2003) 182 CTR (Mad)461
[107] Sec 80 of Income Tax Act, 1961
[108] Sec157 of Income Tax Act, 1961
[109] Proviso to s 72(1) of Income Tax Act, 1961.

(a) Short term capital loss- A short term capital loss may be :

(i) Set off in the same year against any capital gains whether short term or long term [110]

(ii) carried forward and set off against any capital gains whether short term or long term[111]

(iii) carried forward for eight years[112]

(b) Long term capital loss-A long term capital loss may be

(i) set off in the same year against a capital gain from long term asset[113]

(ii) carried forward and set off against a capital gain from long term asset [114]

(iii) carried forward for eight years

Losses in Speculation Business[115]. 'Speculative transaction' is defined by s 43(5), qv. Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the .business is regarded as speculation business within Explanation 2 to s 28. But a single speculative transaction would not amount to a 'speculation business' within that explanation, and consequently, would not attract the provisions of s 73.[116] Similarly, loss on sale of units within one month of their purchase is not a speculative loss.[117] Unlike other losses, a loss in a speculation business cannot be set off under s 70 against any income under the same head, viz business or profession[118]nor can it be set off under s 71 against income under. any other head, but it can be set off only against profits, if any, of another speculation business[119] The loss of a speculation business cannot be set off even against profits of the same business of which speculation forms a part in reality

[110] 70(2) of Income Tax Act, 1961
[111] 74(1)(a) of Income Tax Act, 1961
[112] 74(2) of Income Tax Act, 1961
[113] 70(3) of Income Tax Act, 1961
[114] 74(1)(b) of Income Tax Act, 1961
[115] Sec 73 of Income Tax Act, 1961
[116] *Mysore Rolling Mill v CIT* 195 ITR 404
[117] *CIT v Laksmi Mills Co Ltd* 290 ITR 663
[118] *CIT v park View* 261 ITR 473; *CIT v Shivlal Dhirajlal* 193 ITR 196
[119] s 73(1) of Income Tax Act, 1961

because speculation is deemed, by a fiction of law to be distinct and separate from any other business[120] Thus commission earned by a broker for carrying out speculative transactions on behalf of his clients is not income from speculation business, even if the broker carries on speculation business on his own account.[121] If a liability of the assessee had been originally allowed· in computing the profits or loss of a speculation business, when that liability is subsequently remitted, it should be assessed as income under s 41(1) from the speculation business.[122]An assessee who incurs a loss in a speculation business carried on by him individually is entitled to set it off against his share of the profits in another speculation business carried on by a firm in which he is a partner[123]

In *CIT v Kothari*[124] the Supreme Court held that a loss in an illegal speculation business can be adjusted against profits from the same business, but it cannot be set off under this section against profits from another speculation business. The ground of the decision was that s 43(5) defines a 'speculative transaction' by reference to a 'contract', and 'contract' means a lega1 and enforceable contract and does not include an illegal agreement which is unenforceable. This part of the decision is erroneous. The fallacy underlying the reasoning is that it treats the loss as arising from a speculation business although the speculative transactions are illegal, but when it comes to considering the claim to set off the loss against profits from another speculation business, it applies a different criterion and reads speculation business as restricted to legal speculative transactions. If the definition of 'speculative transaction' is to be restricted only to legal and enforceable transactions, how can the loss arising in an illegal business at all attract the restriction imposed by this section, since, ex hypothesis the loss is not in a speculation business? If the word 'contract' is to be confined only to a legally enforceable agreement, then an illegal agreement, not being a contract, would fall outside the definitions of 'speculative transaction' and 'speculation business'; and the result would be that the right to set off the loss arising in respect of illegal speculative agreements would not be subject to the restriction contained in s 73 but would be governed by the general provisions of ss 70 and 71, and the assessee would be entitled

[120] Explanation 2 to section 28 of Income Tax Act, 1961.
[121] *CIT v Pangal* 74 ITR 754 SC; *CIT v Jhunjhunwalla* 139 ITR 371
[122] *Rajputana Trading* v *CIT* 72 ITR 286 SC
[123] *Ramanalal v CIT* 31 ITR 924
[124] 82 ITR 794

to set off such loss· against profits from his non-speculation business. This unacceptable consequence is obviated if the expression 'contract' in s 43(5) is not interpreted in its strict and technical sense as referring only to a legally enforceable agreement, but is construed in the ordinary sense as including any agreement, legal or illegal, which is 'speculative' in terms of the definition. The Gujarat High Court in *CIT v Ranjitsitihji Oil Mills Ltd*[125] read down the Supreme Courts above finding and interpreted the judgment as merely holding that the loss an illegal speculative activity can be adjusted against profits from a legal speculative activity where such activities constitute same business and that such loss cannot be adjusted m any other case. The correct position is that a loss in any speculation business, legal or illegal, can be set off under this section against the profits of any other speculation business, legal or illegal. Following Kothari, the Supreme Court held in *CIT v Kurji Kotecha*[126] that the unabsorbed loss in an illegal speculation business cannot be earned forward to the next year even if such business is continued in that year. sale of shares,[127] such company

Under sub-s (2) a loss in a speculation business can be carried forward to a subsequent year and set off only against the profits of any speculation business carried on in that year even if the profits are of a speculation business distinct and separate from .the speculation business in which the loss had been incurred and even if that speculation business in which the loss had been incurred was discontinued prior to such subsequent year." This provision constitutes a departure from two principles applicable to other business losses, viz that a loss can be carried forward set off against the profit of any business, profession or vocation, and that the business in which the carried forward loss was incurred should continue to be carried on in the subsequent year. Like other business losses under s 72, losses in speculation business under this section can be carried forward only for a period of eight years. The contemplated by this section includes bad debts, e.g. irrecoverable profits, in speculation business which are written off, and interest on amounts borrowed for that business.[129] Under the explanation, where any part of the business of a company, other than an investment company, or a banking or financing company, consists in the purchase and

[125] 109 ITR 405 ; *CIT v Shivlal Dhirajlal* 193 ITR 196
[126] 107 ITR 101
[127] Apollo Tyres lltd v CIT 255 ITR 273 SC; CIT v Arvind Inv Ltd 192 ITR 365, Mysore Rollings v CIT 195 ITR 404

shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of shares. A speculation business is always deemed to be distinct and separate from any other business[128]. But the fiction embodied in the explanation to this section is only 'for the purposes of this section', i.e. where losses are incurred in shares and are sought to be set off against other income; and therefore, this explanation would have no application to a case where losses are incurred in another part of the business and are sought to be set off against profits in shares or other income. Similarly, the fiction created by the Explanation cannot be used for any purpose other than for which it is created. 36

In order to determine whether the Explanation applies, the gross total income must be computed to ascertain whether it consists mainly of income chargeable under the head referred to in the Explanation. Although an Explanation normally does not enlarge the scope of the original section, if it has widened the scope of the main section, effect should be given to the legislative intent. The Explanation to s 73 must be read in this light. It is the intention of the Legislature that any loss, computed in respect of a speculation business carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business. If the assessee is a company indicated in the Explanation to s 73, the meaning of "speculation business" is different from the one applicable to other types of asses sees. The ref ore, even transactions which are not speculative transactions within the meaning of s 43(5) of the Act, should be deemed to be speculative if they came within the purview of the Explanation to s 73. The definition of "speculative transaction" in s 43(5) cannot be read into the provisions of s 73. Having regard to the plain meaning of this section, an assessee who is carrying on speculation business and has earned profits during an assessment year, is entitled to set-off the losses that have been incurred in the speculation business in the earlier years and carried forward.[129]

Where there was a finding of fact that the assessees main business was the granting of loans, it was held the losses from the share dealing could be set off against the profits from

[128] Explanation 2 to s 28
[129] CIT v Lokmat Newspaper Pvt Ltd 322 ITR 43; CIT v International Trade LTD 285 ITR 536, CIT v Micro Ltd 290 ITR 389

the business under s 72.[130] Even in cases where a company has shares as stock-in-trade, but does not deal with them during the relevant assessment year, simply by virtue of holding them as stock-in-trade, it will be deemed to be carrying on speculative business.[131]" The result is that in the case of a company which .carries on a single business of which dealing in shares is a part

(i) if a loss is incurred in shares, it would be treated as a loss in speculation business and would be dealt with in accordance with the provision of Sec 73

(ii) if a loss is incurred in any other part of the business it can be adjusted against · profits in shares and any unabsorbed loss can be carried forward and set off . · against profits in shares under s 72(1) in a subsequent year in which such other part of the business may not be continued to be carried on but only dealing in shares continues to be carried on. The reason is that in that case the same business in fact would continue to be carried on as required by the proviso to sec72 (1)(i). The legal fiction enjoined by this explanation which is limited to s 73 (losses in shares) would have no application.

5.3.5 Carry forward and Set off of loss in case of change in shareholding.[132] There was no provision m the 1922 Act corresponding to this section. It applies only to companies m which the public are not substantially interested[133]Such a company may become disentitled to carry forward and set off an earlier year's loss against the income of the accounting year, if on the last day of the accounting year shares carrying at least 51 per cent of the voting power are not beneficially held by persons who beneficially held shares carrying at least 51 per cent of the voting power on the last day of the year in which the loss was incurred. The reference in the section is not to the registered shareholders but to the beneficial owners of the shares. The section would not apply if shares carrying 51 per cent of the voting power continue to be held by the same group which held shares carrying 51 percent of the voting power in the year in which the loss was incurred although within the group itself there may be any amount of change of shareholding. The proviso to the section, inserted with effect

[130] *PUBCL Industrial Ltd v CIT* 337 ITR 536
[131] *Prasad Agents P Ltd v ITO* 333 ITR 275,
[132] Section 79 of Income Tax Act, 1961
[133] Sec 2(18) of Income Tax Act, 1961

from April 1, 1989, makes the section inapplicable where a change in such voting power takes place as a result of the death of a shareholder or gift of shares by a shareholder to his relative [s 2(41).] The first circumstance -death of a shareholder-was inherent in the pre-1989 law which is dealt with latter. The second proviso to the section, inserted with effect from April 1, 2000 by the Finance Act, 1999, makes the section inapplicable to any change in the shareholding of an Indian company which is a subsidiary of a foreign company as a result of amalgamation or demerge of a f foreign company, subject to the condition that 51 per cent of the shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or the resulting foreign company. The law prior to the assessment year 1989-90 provides that even if shares carrying 51 per cent of the voting power cease to be held by the same group, the section would not apply to the company if the Assessing Officer is satisfied that the change in the shareholding was not effected with a view to avoiding or reducing any liability to tax' .If the change in the shareholding was effected ·not with that object but with some other object in view, the section would not apply and the company's right to carry forward and set off the loss would not be lost even though the result of the change in the shareholding may be, negation or reduction of tax liability. The section looks at the motive behind the change in the shareholding and not at its effect.

5.4 Permissible deduction:

Section	Nature of Deduction
80G	Donations to charitable institutions and funds
80GGA	Donation for scientific research or rural development
80GGB	Contribution to political parties
80IA	Profits and gains from industrial undertaking engaged in infrastructure development undertaking

80IAB	Profits and gains from industrial undertaking or enterprise in development of SEZ
80 IB	Profits and gains from industrial undertakings other than infrastructure development undertakings
80IC	Profits and gains of certain undertakings in Certain states
80ID	Profits of hotels and convention centers
80IE	Profits of undertakings in North Eastern States
80JJA	Profits from business of collecting and processing of biodegradable waste
80JJAA	Employment of new workmen
80LA	Income of offshore banking units

5.5 Tax Liability

Computation I-Under Normal provisions	Computation II-Under minimum alternate tax
Step 1: Find out taxable income under normal provisions	Step 8: Find out the book profits
Step 2: Find out income tax at the rate of 30% (40% for foreign company) of income computed in Step 1	Step 9: Find out 18.5% of book profits
Step 3: Add surcharge	Step 10: Add surcharge
Step 4: Find out 2+3	Step 11: Find out (9) + (11)
Step 5: Add education cess at the rate of 2% of step 4 and secondary higher cess at the rate of 1% of (4)	Step 12: Step 5: Add education cess at the rate of 2% of step (11) and secondary higher cess at the rate of 1% of (11)
Step 6: Deduct tax rebate or tax credit under section 86,90,90A, and 91E	Step 13: Find out 11+12
Step 7: Find out (4)+(5) –(6) [It cannot be less than 0]	

Chapter 6. Tax Planning

Tax avoidance by using artificial devices such as holding companies, subsidiaries, treaty shopping, and selling valuable rights and properties indirectly by entering into a maze of framework agreements has become a very lucrative industry in the world today. A large part of the work and income of the so-called big five accountancy and consultancy firms in the world is derived from devising this kind of innovative tax avoidance schemes and devices which flourish in the name of tax planning. The issue as to whether the courts should sanction such methods of tax avoidance in the name of tax planning has agitated the judiciary in India and abroad for a long time now. A five-judge bench of the Supreme Court crystallized the ruling view on this in 1985 in the judgment of McDowell and Co[136] where Justice Mishra writing for four judges observed: Tax planning may be legitimate provided it is within the framework of law. Colorable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges. On this aspect one of us, J Chinnappa Reddy, has proposed a separate and detailed opinion with which we agree. Justice Reddy wrote: I have referred to the English cases, at some length, only to show that in the very country of its birth, the principle of Westminster has been given a decent burial and in that very country where the phrase 'tax avoidance' originated the judicial attitude towards tax avoidance has changed and the smile, cynical or even affectionate though it might have been at one time, has now frozen into a deep frown. The Courts are now concerning themselves not merely with the genuineness of a transaction, but with the intended effect of it for fiscal purposes. No one can now get away with a tax avoidance project with the mere statement that there is nothing illegal about it. We think that time has come for us to depart from the Westminster principle as emphatically as the British Courts have done and to dissociate ourselves from the observations of Shah, J and similar observations made elsewhere. The evil consequences of tax avoidance are manifold. First there is substantial loss of much needed public revenue, particularly in a welfare State like ours. Next there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation. Then there is "the large hidden loss" to the community by some of the best brains in the country being involved in the perpetual war waged between the tax-avoider and his expert team of advisers, lawyers and accountants on one side and the tax-gatherer and his perhaps not so skillful advisers on the other side. Then again there is the "sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it".

Last but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guileless good citizens from those of It may, indeed, be difficult for lesser mortals to attain the state of mind of Mr. Justice Holmes, who said, "*Taxes are what we pay for civilized society. I like to pay taxes. With them I buy civilization.*" But, surely, it is high time for the judiciary in India too to part its ways from the principle of Westminster and the alluring logic of tax avoidance, we now live in a welfare State whose financial needs, if backed by the law, have to be respected and met.

We must recognize that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it. A hint of this approach is to be found in the judgment of Desai, J in Wood Polymer Ltd and Bengal Hotels Limited[136] where the learned Judge refused to accord sanction to the amalgamation of companies as it would lead to avoidance of tax. 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 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 was done in Ramsay[137], Burma Oil[138] and Dawson [139] "to expose the devices for what they really are and to refuse to give judicial benediction".

6.1 Azaadi Bachao Andolan case: Despite such a clear and authoritative pronouncement

by a five-judge bench of the Supreme Court mandating that the courts must sternly frown upon any artificial device adopted by corporations to avoid tax, two recent judgments of smaller benches of the Supreme Court have tried to overturn it by winking at such artificial tax avoidance devices and calling them legitimate tax planning. The first case is that of Azaadi Bachao Andolan[136] of 2004. Consider the facts. On 29 March 2000, an intrepid income tax officer of Mumbai issued a remark- ably bold assessment order in respect of several foreign institutional investors (FIIs) which were playing the stock market in India and making huge profits, mainly capital gains, and yet not paying any taxes in India. Though the Indian Income Tax Act obliges even a non-resident to pay taxes on incomes earned in India, these FIIs were avoiding paying those taxes by claiming the benefit of the Double Taxation Avoidance Treaty with Mauritius. This treaty signed in 1983, which applies to residents of India, or Mauritius essentially provides that a company would be taxed only in the country where it is domiciled.

All these FIIs, though based in other countries and operating exclusively in India, claimed to be domiciled in Mauritius by virtue of being registered there under the Mauritius Offshore Business Activities Act (MOBA). Companies registered under this Act are not allowed to acquire any property in, deal with any resident in, raise any funds in, make any investment in or conduct any business in Mauritius. Yet these "Post Box Companies" had been claiming to be domiciled in Mauritius and therefore claiming the benefit of the treaty.

The IT department allowed them to get away with it for many years. And there was no capital gains tax and virtually no tax at all on these companies in Mauritius. So all that a foreign company had to do in order to do business in India without paying any tax was to register itself or a subsidiary as an off- shore company under MOBA in Mauritius. Naturally, seeing the benign attitude of the Indian tax authorities, by the year 2000, most of the FIIs and most of the foreign investment in India (in the stock market or otherwise) came to be routed through Mauritius. Then this proactive ITO tried to put a stop to this blatant tax evasion. He cited Supreme Court judgments to say that the tax authorities must frown upon tax evasion and lifted the corporate veil of these companies to see their actual place of residence or domicile. This happened to be in different countries in Europe or the United States. Thus the relevant double tax avoidance treaty would be the one between India and that country. All these treaties provided that capital gains tax would be levied in the country where the gains had accrued. Since the gains had accrued in India, he levied capital gains tax and also issued penalty notices to these FIIs. All hell broke loose with this order of the ITO.

> Panicky FIIs having gotten used to tax-free lunches in India approached the then finance minister Yashwant Sinha. He immediately promised them that he would get the order of the ITO reversed and even announced it the next day. And he delivered on that promise. On 13 April 2000, the Central Board of Direct Taxes (CBDT) (directly under the finance minister, and directly above the income tax authorities) issued a circular to all tax authorities in India that once a company had obtained a tax residence certificate from Mauritius, it would not be taxed in India. Of course Sinha's decision, as he claimed, was motivated entirely by fears of foreign investment drying up in India. It obviously had nothing to do with the fact that his daughter-in-law, Puneeta Sinha, was in charge of one of the largest such foreign funds operating in the Indian stock market (The India Fund) and her company had earned several million dollars as com- mission on the profits made by her fund during the previous year.

The CBDT's circular was challenged in the Delhi High Court in PILs filed by the Azaadi Bachao Andolan and a retired chief commissioner of income tax, S K Jha. It was argued that the circular violated the Income Tax Act inasmuch as it mandated the ITO to accept the certificate issued by the Mauritius authorities and prohibited the Indian authorities from examining the real domicile of these companies. It thus effectively subordinated the Indian tax authorities to the Mauritius authorities, which was not permitted by Indian law. It also encouraged "treaty shopping" and tax evasion by these companies, which had nothing to do with Mauritius. It had been estimated that the tax thus evaded by these foreign companies in 1999-2000 alone ran into several thousands of crores of rupees. It was also pleaded by Jha that the Indian government be directed to amend the treaty with Mauritius, especially after it had become a tax haven with characteristic opaqueness about the nature of the companies registered there. A division bench of Chief Justice S B Sinha and Justice A K Sikri allowed the writ petitions on 31 May 2002 and quashed the CBDT circular holding that it was violative of the Income Tax Act and would encourage treaty shopping and tax avoidance by companies, which had nothing to do with Mauritius.

A double taxation avoidance treaty can only be for avoiding double taxation and not for political expediency or for tax avoidance altogether. The government went to the Supreme Court where it argued that such a circular, which effectively allowed a tax holiday to foreign companies, was needed to attract foreign investment in India. The public interest petitioners in the court pointed out that tax exemptions to anyone could only be granted by Parliament by either amending the Income Tax Act or by the Finance Act (budget) passed each year. But the government could not by itself grant such exemption in the guise of such a circular promoting such an artificial device of a company registered as a "non- resident" company in Mauritius being recognized as a Mauritius resident. How- ever, a bench of Justice Srikrishna and Justice Ruma Pal in the Supreme Court, by calling this device an act of legitimate tax planning which could be promoted by the government to attract foreign investment, defied the Constitution bench judgment in McDowell, winked at the CBDT circular and set aside the Delhi High Court judgment.

6.2 Vodafone Tax Case

In the Vodafone tax case[134], which was heard by a three-judge bench of the Supreme Court, the Court had the opportunity to correct the transgression of the McDowell principle in the

[134] *Vodafone International Holding BV v. Union of India* (**2012**) 6 **SCC** 613

Mauritius case. Consider the facts of this case. In 2007, Hutchinson Telecom Inter- national which was directly or indirectly holding 67% of the shareholding of Hutch Essar Limited, an Indian telecom company, sold its entire holding to Vodafone Inter- national (another foreign company) for an amount of over $11 billion. Both companies issued press releases announcing that Hutchinson had sold and Vodafone had bought 67% of the shares and interest in the Indian company for over $11 billion.

The Bombay High Court in the following words has described how this was achieved: A Sale Purchase Agreement ("SPA") was entered into on 11 February 2007 between Hutchison Telecommunications International Limited (HTIL) and Vodafone International Holdings B V (VIH BV). The Agreement contains the following two recitals: "(A) CGP is an indirect wholly-owned subsidiary of the Vendor. CGP owns, directly or indirectly, companies which control the Company Interests, (B) The Vendor has agreed to procure the sale of and the Purchaser has agreed to purchase the entire issued share capital of CGP on the terms and conditions set out in this Agreement. The Vendor has further agreed to procure the assignment of, and the Purchaser has agreed to accept an assignment of, the Loans on the terms and conditions set out in this Agreement and the Loan Assignments." 'Company interests' are defined to be the aggregate interests in 66.9848% of the issued share capital of Hutchison Essar Limited (HEL).

The diverse clauses of the SPA are indicative of the fact that parties were conscious of the composite nature of the trans- action and created reciprocal rights and obligations that included, but were not con- fined to the transfer of the CGP share. The commercial understanding of the parties was that the transaction related to the transfer of a controlling interest in HEL from HTIL to VIH BV. The transfer of control was not relatable merely to the transfer of the CGP share. Inextricably woven with the transfer of control were other rights and entitlements which HTIL and/or its subsidiaries had assumed in pursuance of contractual arrangements with its Indian partners and the benefit of which would now stand transferred to VIH BV. By and as a result of the SPA, HTIL was relinquishing its interest in the telecommunications business in India and VIH BV was acquiring the interest which was held earlier by HTIL.

Subsection (1) of Section 9 of the Indian Income Tax Act stipulates incomes which shall be deemed to accrue or arise in India. Clause (i) of subsection (1) is to the following effect: "(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India." Claiming that the capital gain to Hutch had accrued from the transfer of the shares and assets of the Indian telecom business to Vodafone, the income tax department demanded capital gains tax on this transaction and pursued Vodafone which was liable to withhold this tax from the amount they paid to Hutch and pay to the income tax department. Vodafone, however, claimed that the transaction was not liable to tax since it was achieved by transferring the shares of a Cayman Island based holding company. Thus it said that the transaction did not involve the transfer of a capital asset situated in India. The high court rejected this contention by holding:

132. The facts clearly establish that it would be simplistic to assume that the entire transaction between HTIL and VIH BV fulfilled merely upon the transfer of a single share of CGP in the Cayman Islands. The commercial and business understanding between the parties postulated that what was being transferred from HTIL to VIH BV was the controlling interest in HEL. HTIL had through its investments in HEL carried on operations in India which HTIL in its annual report of 2007 represented to be the Indian mobile telecommunication operations. The transaction between HTIL and VIH BV was structured so as to achieve the object of discontinuing the operations of HTIL in relation to the Indian mobile telecommunication operations by transferring the rights and entitlements of HTIL to VIH BV. HEL was at all times intended to be the target company and a transfer of the con- trolling interest in HEL was the purpose which was achieved by the transaction. Ernst and Young who carried out a due diligence of the telecommunications business carried on by HEL and its subsidiaries have made the following disclosure in its report: The target structure now also includes a Cayman company, CGP Investments (Holdings) Limited. CGP Investments (Holdings) Limited was not originally within the target group. After our due diligence had commenced the seller proposed that CGP Investments (Holdings) Limited should be added to the target group and made available certain limited information about the company. Although we have reviewed this information, it is not sufficient for us

to be able to comment on any tax risks associated with the company. The due diligence report emphasizes that the object and intent of the parties was to achieve the transfer of control over HEL and the transfer of the solitary share of CGP, a Cayman Islands company was put into place at the behest of HTIL, subsequently as a mode of effectuating the goal.

133. The true nature of the transaction as it emerges from the transactional documents is that the transfer of the solitary share of the Cayman Islands company reflected only a part of the arrangement put into place by the parties in achieving the object of transferring control of HEL to VIH BV. HTIL had put into place, during the period when it was in control of HEL, a complex structure including the financing of Indian companies which in turn had holdings directly or indirectly in HEL. In consideration call and put options were created and the benefit of those options had to be transferred to the purchaser as an integral part of the transfer of control over HEL. Hence, it is from that perspective that the framework agreements pertaining to the Analjit Singh and Asim Ghosh group of companies and IDFC have to be perceived. These were agreements with Indian companies and the transaction between HTIL and VIH BV takes due account of the benefit of those agreements.

134. The price paid by VIH BV to HTIL of US $11.01 billion factored in, as part of the consideration, diverse rights and entitlements that were being transferred to VIH BV. Many of these entitlements were not relatable to the transfer of the CGP share. Indeed, if the transfer of the solitary share of CGP could have effectuated the purpose it was not necessary for the parties to enter into a complex structure of business documentation. The transactional documents are not merely incidental or consequential to the transfer of the CGP share, but recognized independently the rights and entitlements of HTIL in relation to the Indian business which were being transferred to VIH BV. The diverse clauses of the SPA are indicative of the fact that parties were conscious of the composite nature of the transaction and created reciprocal rights and obligations that included, but were not confined to the transfer of the CGP share. The commercial understanding of the parties was that the transaction related to the transfer of a con- trolling interest in HEL from HTIL to VIH BV.

The transfer of control was not relatable merely to the transfer of the CGP share. Inextricably woven with the transfer of control were other rights and entitlements which HTIL and/or its subsidiaries had assumed in pursuance of contractual arrangements with its Indian partners and the benefit of which would now stand transferred to VIH BV. By and as a result of the SPA, HTIL was relinquishing its interest in the telecommunications business in India and VIH BV was acquiring the interest, which was held earlier by HTIL. The high court thus rejected the contention of Vodafone that this transaction was not liable to tax. The approach of the high court was perfectly in line with the binding judgment of the Constitution Bench in McDowell and Co where the Court decisively frowned upon tax avoidance schemes. But despite it being clear that Hutch had created this corporate structure only to avoid paying tax on the capital gains accruing from the sale of its stake in the Indian telecom company and its assets, the Supreme Court bench of three judges headed by Chief Justice Kapadia accepted Vodafone's claim that the capital gain had arisen only from the transfer of the single share in the Cayman Island company and therefore had nothing to do with the transfer of any asset situated in India and therefore does not fall within Section 9 of the Income Tax Act.

He said: This problem has arisen also because of the reason that this case deals with share sale and not asset sale. This case does not involve sale of assets on itemised basis. The High Court ought to have applied the look at test in which the entire Hutchison structure, as it existed, ought to have been looked at holistically. This case concerns investment into India by a holding company (parent company), HTIL through a maze of subsidiaries. When one applies the "nature and character of the transaction test, confusion arises if a dissecting approach of examining each individual asset is adopted. As stated, CGP was treated in the Hutchison structure as an investment vehicle. As a general rule, in a case where a transaction involves trans- fer of shares lock, stock and barrel, such a transaction cannot be broken up into sepa- rate individual components, assets or rights such as right to vote, right to participate in company meetings, management rights, controlling rights, control premium, brand licenses and so on as shares constitute a bundle of rights.

Further, the High Court has failed to examine the nature of the following items, namely, non-compete agreement, control premium, call and put options, consultancy support, customer base, brand licenses etc. On facts, we are of the view that the High Court, in the present case, ought to have examined the entire transaction holistically. VIH has rightly contended that the transaction in question should be looked at as an entire package. The items mentioned hereinabove, like control premium, non-compete agreement, consultancy support, customer base, brand licenses, operating licenses, etc, were all an integral part of the Holding Subsidiary Structure which existed for almost 13 years, generating huge revenues, as indicated above. Merely because at the time of exit capital gains tax becomes not payable or eligible to tax would not make the entire "share sale" (investment) a sham or a tax avoidant. The High Court has failed to appreciate that the payment of $11.08 bn was for purchase of the entire investment made by HTIL in India. The payment was for the entire package.

The parties to the transaction have not agreed upon a separate price for the CGP share and for what the High Court calls as "other rights and entitlements" (including options, right to non-compete, control premium, customer base, etc). Thus, it was not open to the Revenue to split the payment and consider a part of such payments for each of the above items. The essential char- acter of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or on the basis that the payment is related to a contingency ('options', in this case), particularly when the transaction does not contemplate such a split up. Where the parties have agreed for a lump sum consideration without placing separate values for each of the above items which go to make up the entire investment in participation, merely because certain values are indicated in the correspondence with FIPB which had raised the query, would not mean that the parties had agreed for the price payable for each of the above items. The transaction remained a contract of out- right sale of the entire investment for a lump sum consideration.

Thus, despite the fact that it was clear that the entire object and purpose of the transaction between Hutch and Vodafone was to transfer the shares, assets and control of the Indian telecom company to Vodafone, the Supreme Court declares that the transaction has nothing to do with the transfer of any asset in India! This judgment enshrines the use of artificial devices for tax avoidance as legitimate "tax planning" which the Court should allow and

even encourage for "attracting foreign direct investment". Justice Radhakrishnan begins his judgment by extolling the virtues of FDI. In his words: The question involved in this case is of considerable public importance, especially on Foreign Direct Investment (FDI), which is indispensable for a growing economy like India. Foreign investments in India are generally routed through Offshore Finance Centres (OFC) also through the countries with whom India has entered into treaties. Over- seas investments in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) have been recognized as important avenues of global business in India. Potential users of off-shore finance are: international companies, individuals, investors and others and capital flows through FDI, Portfolio Debt Investment and Foreign Portfolio Equity Investment and so on.

With such benign, indeed welcoming winking towards tax avoidance devices, it is unlikely that any foreign company would be called upon to pay tax or at least capital gains tax in future in India. Lakhs of crores of tax revenue of this country and the future attitude of the courts towards innovative tax avoidance devices being adopted more and more by international corporations would be shaped by these two judgments.

Chapter 7 Recommendation and Conclusion

It is widely accepted that it is desirable to have an optimum mix of lower statutory tax rates with lower fiscal incentives to induce greater tax compliance and to reduce tax evasion. Even a marginal reduction in the statutory tax rate is vivid and direct and generates a far more positive psychological response than a large number of fiscal incentives which are conditional and of indirect nature, remaining at best camouflaged. Lower tax rates together with few fiscal incentives attuned to, say, new investment, area development, export promotion, etc, can serve a more practical purpose than a plethora of tax reliefs combined with high tax rates which have adverse demonstration effect and also yield reduced revenue to the government. Moreover, liberalized rates of depreciation allowance confer large tax benefits on the corporate sector. Thus, the tax rationalization policy has to be so designed as to serve the twin objectives of not only promoting industrial growth coupled with social objectives but also of ensuring accrual of reasonable tax revenue to the exchequer. Further, the balance sheets and annual reports of the companies do not provide full details of the fiscal incentives availed of by them in computing their taxable income. Since the availability of this information has important implications both for obtaining a clearer picture of the companies' accounts, operations and tax management practices and also for enabling the government and shareholders to find out the nature and types of fiscal incentives utilized by them for drawing appropriate inferences for the proper formulation and rationalization of the incentive schemes, it is desirable that statutory provision is introduced making it incumbent on the companies to disclose the scheme wise details of tax concessions availed of by them. There is ample scope for leakage of revenue, for instance, in the provision regarding donations for scientific research and rural development allowed under Section 80 GGA. Under this section, deductions are, inter alia, allowed to an association or institution for rural development or training of persons for rural development programmes and to an association or institution for programmes of conservation of natural resources or afforestation and also to universities, colleges or institutions approved for social science or statistical research. These provisions should be confined only to universities and institutions of national stature to prevent their misuse. There are also several other provisions under various sections of the Income Tax Act which need to be tightened and loopholes plugged. There is generally an agreement among economists and experts that with an increase in the number of fiscal incentives, their ultimate impact is weakened and to bring about the desired impact each new incentive has to be propped up with supplementary as well as complementary incentives, as in the case of rural development programmes in India. Secondly, there is no certainty about either the ultimate impact or the effectiveness of fiscal incentives as the implementation allows large-scale misutilisation. Therefore, the system of fiscal incentives should be brief, unambiguous, simple and effective.

Depreciation implies diminution in the value of assets due to wear and tear caused by their use over a period of time and as such depreciation allowance is intended to meet the replacement cost of assets. The amount of depreciation provision to be made by a company depends, inter alia, on the scale or method of its calculation, i e, written down value method and straight line method and the period over which it is to be written off, which may generally extend over the useful life of an asset. Much higher rates of depreciation are admissible under the Income Tax Act as compared to those under the Companies Act. Arguments are advanced both for and against this practice on theoretical as well as practical premises. Theoretically speaking, the logic behind higher rates of depreciation allowed under the Income Tax Act is to enable larger cash flows in the early years of the life of the assets so that renovation and the ultimate replacement of the asset is well provided for at an early stage. The purpose of lower rates of depreciation allowed under the Companies Act is to fairly spread the charging of the company's income over the useful life of the asset. Thus, the company's performance presents a picture of higher profitability to the 'investors due to lower provision for depreciation deduction in the company's accounts under the Companies Act and, therefore, it keeps up and even spurs investors' interest. There is some truth in the above argument but not the entire truth. Actually, by artificially jacking up the cash flow of the company in the initial years, it builds up unrealistic expectations of higher dividend pay-outs among shareholders and thus acts as a drain on the resources and savings of the company which are otherwise meant to be used for reinvestment in the company for the replacement of assets. Instances abound where loss-making companies continue to disburse dividends from their reserves and thus fritter away corporate savings instead of channelizing them to restore the companies to good health and profitability. Thus, the original purpose of providing higher depreciation in the initial years has been obliterated over time due to the ingenious practices pursued by the corporates. Companies are also allowed to revalue their assets periodically and charge higher depreciation on revalued assets in their accounts under the Companies Act but historical cost has to be taken into account for the purpose of computing depreciation and the subsequent income tax liability under the Income Tax Act. In case an asset is disposed of in the course of its useful life span, it fetches a market price which is related to the price of the new asset and not its historical price and, therefore, a company is compensated to an extent for the rise in the replacement cost of assets. It is further argued that since companies are allowed to prepare two sets of accounts - one for the income tax purpose and the other for the shareholders and the general public - it reduces transparency in the companies' accounts and leaves room for manipulative practices. By presenting a better picture of corporate performance to shareholders under the Companies Act and by playing it down to the tax authorities under the Income Tax Act for income tax purpose, a confusing situation arises. The positive aspects of having two different sets of depreciation rates under the Companies Act and the Income Tax Act are counter- balanced by the negative aspects. It is desirable to strike a balance between the high rates of depreciation allowed under the Income Tax Act and low rates of depreciation admissible under the Companies Act and fix a common general rate of depreciation at 20 per cent with further harmonization of the depreciation rates admissible in respect of specific blocks of assets. This step alone would bring in at least as much additional revenue to the government.

On the face of it, taxing the income of shareholders from dividend paid out of the taxed profits of a company amounts to double taxation. Should then companies be subjected to tax at all? In the economists' view, equity in taxation relates to individuals and can have no meaning in the case of juridical entities like companies, particularly when who bears the tax burden remains uncertain. That apart, corporate taxes tend to distort choices regarding the organizational form of businesses ("to incorporate or not?"), the financial structure (debt-equity ratio) and dividend payout policy. Variations in effective tax rates can also distort investment choices regarding industry, location, factor mix and risk taking. Taxes on capital income can influence inter-temporal decisions as well, reducing saving and thereby growth. Complexity of tax laws and the costs involved in compliance may deter the entry of small and new firms.

Since manufacturing is of paramount importance, in Budget 2014-15, investment allowance to manufacturing company investing more than 100 crores in plant and machinery during April 1, 2013 to Mar 31, 2015 was announced. Responding the need to incentivize smaller entrepreneur, a manufacturing company investing more than 25 crores in a year in plant and machinery is allowed 15 percent investment allowance. The same benefit is applicable to investments up to Mar31, 2017. Such a step is of great help to the corporates. Moreover there is an urgent need to provide incentives in form of tax holidays to various sectors in order to facilitate the companies to achieve generation of employment and full potential.

Corporate taxation in India has in recent years undergone a number of frequent revisions, and the basic rate of corporate taxation has been reduced gradually which in the present scenario has been to be a step towards existence and survival of corporate entities though the complexities of the tax structure is required to be curtailed.