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INTERNATIONAL TAX PLANNING FROM AN INDIAN PERSPECTIVE: CONTRACTS, STATUS AND THE JUDICIARY

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INTERNATIONAL TAX PLANNING FROM AN INDIAN PERSPECTIVE: CONTRACTS, STATUS AND THE JUDICIARY

NIGAM **NUGGEHALLI**[*]

I. THE ENGLISH JUDICIARY AND TAX PLANNING

The judiciary in England tends by and large to acknowledge that the tax status of taxpayers is primarily determined by the contractual relationships entered into by taxpayers. In fact, the first celebrated case on tax avoidance is also the first case to bring out the special connection between contracts and taxation. In *Inland Revenue Commissioners v Duke of Westminster*,[1] the Duke of Westminster paid wages to a retinue of staff including his gardener Frank Allman. The tax law at that time in the United Kingdom ("UK") did not allow the Duke to deduct the wages paid to his staff from his taxable income. On the other hand, the law allowed a deduction of annuities paid to other people.[2] UK tax law—at the time the *Westminster* case was decided—allowed annuities to be deducted from the income of the Duke but not salaries paid to the Duke's employees. The Duke entered into a simple tax avoidance scheme. He bestowed annuities on his employees in the form of "executed deeds of covenants".[3]

The covenant executed in favour of his gardener Frank Allman was a typical example. The covenants promised to pay the gardener a specified weekly sum for a period of seven years in consideration of past services. A letter of explanation was sent to the gardener informing him that there was nothing to prevent the gardener from claiming full remuneration for his work but it would be expected "in practice" that he would be content with the annuities being paid to him.[4] The annuities being paid to the gardener were in fact the equivalent to the wages he was receiving earlier (the letter to the gardener indicated that even if the annuities fell short of the gardener's wages, the Duke would consider making up the difference).[5] When the Duke went ahead and deducted the annuities from his taxable income, the UK revenue challenged the deduction in the courts. The revenue claimed that in substance the Duke was attempting to deduct the otherwise non-deductible wages paid to his employees.

The revenue did not claim that the deed of covenant issued in favour of the gardener was a sham. Indeed, they could not make such a claim. There is a high threshold of proof for sham cases in the common law. The revenue would have had to prove that the drafters of the documents never intended to abide by the terms of the document and that the legal rights and duties created by the document were illusionary and merely a cover for some other reality. The revenue knew they would not prove the Duke's covenants to be a sham. The Duke was perfectly willing to recognize and give effect to the legal rights of the gardener to his annuity.

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1 [1936] AC 1 (HL) [*Westminster*].

2 Annuities and wages are both periodic sums of money but while wages are paid on a current basis, annuities are paid for past services rendered.

3 *Westminster*, *supra* note 1 at 2.

4 *Ibid* at 12.

5 *Ibid.*

Therefore, the revenue went on another path: the notion of substance versus form. In form, the revenue admitted that the deeds of covenants were annuities. But the substance of the transaction, the revenue contended, was to provide wages to the gardener. The revenue's position was understandable. The annuities were equivalent in amount to the wages (with the Duke expected to make up any difference). True, according to the letter, the gardener could have also asked for wages, but considering his position and his relationship with the Duke, the gardener's so called right to wages was so unlikely that the very notion of him standing up to the Duke and demanding his wages in addition to the annuities was laughable.

Yet, the House of Lords was extremely reluctant to ignore the legal rights and duties created by the contract in this case. The Duke's covenants created a legal reality that could not be ignored by the courts. This ability of a citizen to change his tax liability by creating different kinds of contractual rights and duties is a facet of the modern state that has always been acknowledged and the House of Lords was reluctant to disturb the status quo. Lord Tomlin made a remark that was not only to be quoted far into the future by tax lawyers and judges alike but also prove to be a panacea for the tax avoidance industry:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.[6]

The House of Lords came to the conclusion that the legal rights and duties created by the annuities contracts had to be respected, thus allowing the Duke to deduct the annuities from his income. The gardener, you should note, was indifferent to the difference between annuities and wages as under both the contractual regimes he was getting his due. But the Duke, by using different legal documents to channel the gardener's dues, improved his tax circumstances. The *Westminster* case came to be widely regarded as a triumph of contract over status, and matters have remained much the same in the area of tax avoidance despite the supposedly more aggressive approach of the House of Lords in *Ramsay* v *Inland Revenue Commissioners*.[7]

In *Ramsay*, the taxpayer had a capital gain with regard to which the taxpayer entered into a tax avoidance scheme. Each of the transactions in the scheme was a genuine legal transaction, *ie* there was genuine legal documentation for each of the transactions. But the transactions essentially cancelled themselves out while also providing a useful loss to the taxpayer. The revenue could not argue that the tax avoidance scheme was a sham; it most certainly was not. However, they argued that the transaction producing loss and the transaction producing gain should be analyzed together and not separately. Treated separately, the taxpayer was right in claiming a loss; treated together the taxpayer had nothing to gain since there would be notransaction to look at since the two transactions cancelled each other out.

The House of Lords chose to approach the scheme in the following fashion:

> Given that the document or transaction is genuine, the court cannot go behind it to some supposed substance. This is the well-known principle of *IRC v Duke of Westminster*. This is a cardinal principle but it must not be overstated or over-extended. While obliging the court

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6 *Ibid* at 19, 20, Lord Tomlin.

7 [1982] AC 300 (HL) [*Ramsay*].

> to accept documents or transactions found to be genuine as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or a transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the document to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transactions to which it is sought to attach a tax or a tax consequence and if that emerges from a series or a combination of transactions, intended to operate as such, it is that series or combination which may be so regarded.[8]

The Lords in *Ramsay* were careful not to be seen to be overruling the *Westminster* principle, and indeed, the *Ramsay* principle when applied to the *Westminster* case would not have changed the decision in that case presumably because there was only one transaction instead of a series of transactions. As can be seen from the *Ramsay* quote above, the court was also careful not to lay down some version of a substance over form principle, a principle so beloved of American revenue authorities. Perhaps the Lords were reluctant to espouse such a principle for if left unchecked, this principle would be unjust to the taxpayers because it makes it impossible for the taxpayers to contractually structure their transactions in such a way that it has the same or nearly the same economic effect as a taxable transaction while falling outside the terms of the taxing statute. In other words, liberal use of the "substance over form" doctrine could take away the ability of a taxpayer to minimize his taxes through strategic contracts.

The Lords' balancing act in *Ramsay* was a commendable feat of judicial dexterity except for one problem: the artificiality of tax legislation and tax treaties. This was a particularly acute problem when it came to taking advantage of special tax breaks or concessions instituted by statutes or double tax treaties. Taxpayers were able to convince the courts in cases arising after *Ramsay* that the series of transactions undertaken by them had in fact exactly the legal effect envisaged by the relevant tax legislation or tax treaty thus entitling them to tax breaks even if the economics of the transaction were not what the tax legislation was aimed at. This problem was at its most acute in *Barclays Mercantile Business Finance Limited v Mawson.*[9]

The UK revenue alleged in *Barclays* that the taxpayer took advantage of tax legislation providing liberal depreciation deductions to businessmen willing to invest in capital equipment. The taxpayer, which had a banking and equipment leasing business, bought capital equipment at market value from a seller to whom it leased the same equipment at a rate slightly less than the market value of the capital equipment. The difference was the fee the seller received for entering into the transaction.

The taxpayer began using depreciation deductions arising by virtue of the taxpayer's ownership of the capital equipment. The seller put the cash it received from the taxpayer back into the taxpayer's banking business as a "security" for the rent payable on the lease. According to the UK revenue, when the dust cleared, the taxpayer was not out of cash since it had received the bulk of the money back in the form of the security deposit, but it was now entitled to liberal depreciation deductions, and the seller had received a small fee for its part in the transaction.

The House of Lords in *Barclays* gave a decision in favour of the taxpayer in this case. The Lords were satisfied that the statute's purpose had been served as long as there had been a

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8 *Ibid* at 323, 324.

9 [2005] 1 AC 684 (HL) [*Barclays*].

capital investment (in this case, the lessor buying the property and then leasing it). The House of Lords stated:

> [I]f the lessee chooses to make arrangements, even as a preordained part of the transaction for the sale and lease back, which result in the bulk of the purchase price being irrevocably committed to paying the rent, that is no concern of the lessor.[10]

The *Barclays* decision can be seen as an endorsement of the proposition that taxpayers can, except in certain limited circumstances, create their tax status through their contracts.

II. THE INDIAN JUDICIARY AND TAX PLANNING

The Indian case law on tax planning really kicks off with a case that is concerned with sales tax and excise duties rather than income tax provisions. In *McDowell & Company Ltd v The Commercial Tax Officer*,[11] the Supreme Court was faced with an ingenious attempt to avoid the payment of a sales tax. The sales tax legislation in the state of Andhra Pradesh imposed a tax on the *turnover* of companies. The taxpayer was the manufacturer of liquor. Normally the excise tax paid by the taxpayer on the manufacture of the liquor would be part of the price paid by the purchasers and therefore would be part of the taxpayer's turnover. In order to reduce its turnover for sales tax purposes, the taxpayers asked the buyers to pay the excise duty directly to the government. The taxpayer then claimed that the purchase price minus the excise duty was the turnover for sales tax purposes.

The revenue challenged the taxpayer's attempt to reduce its sales tax burden in this manner. When this issue first came before the Supreme Court, the court actually agreed with the taxpayer and stated that the excise duty paid directly by the purchasers did not go into the *common till of* the sellers and as a consequence did not become part of their circulating capital (and by extension, their turnover).[12] As a result, the taxpayer succeeded in reducing their sales tax burden to the extent of the excise duty paid by them.

Immediately after the favourable decision, the government amended the excise rules to make it clear that it was the manufacturer that had to pay the excise duty before liquor was released to the purchasers. Nevertheless, the assessee continued its practice of asking the buyers to pay the excise duty on the liquor directly and argued that the sales tax ought to be paid on the purchase price exclusive of the excise duty.[13] The revenue challenged the assessee's position and once again the same issue reached the Supreme Court.

This time, the Supreme Court refused to give their blessings to this attempt to avoid tax. However, beyond its general denouncement of the evils of tax avoidance, which would be discussed below, the reasons for the Supreme Court's decision were related to the amended excise rules. Since the amended excise rules imposed the duty to pay the excise tax on the

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10 *Ibid* at para 42.

11 [1985] 3 SCR 791 [*McDowell*].

12 *Ibid* at 811.

13 It is unclear from the judgement whether there was an express contract under which the buyers agreed to pay the excise duty on the liquor. The Supreme Court proceeded on the basis that there was an agreement or an arrangement between the seller and the buyer regarding the payment of the excise duty. For *eg*, the court at 817 stated:

> We would like to add, that the position is not different, when under a prior agreement, the legal liability of the manufacturer-dealer for payment of excise duty is satisfied by the purchaser by direct payment to the excise authorities or to the state exchequer.

manufacturer, the buyers making the excise payment instead would be considered as doing so for the seller's benefit. Hence, the consideration for the liquor would include, in addition to the price of the liquor mentioned in the bill, the monetary benefit conferred by the buyer on the seller by paying the excise duty on behalf of the seller.

The Supreme Court further made some comments on the judicial approach to tax avoidance, which, at least for a period of time, caused much trepidation for taxpayers and their advisors:

> 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 of it.[14]

This statement appears to take the position that there was some discretion in the hands of judge to consider whether a tax avoidance measure was permissible even if it was based on a reasonable interpretation of the relevant tax legislation. Although these comments were expressed in a separate opinion of one of the judges (Justice Chinnappa Reddy), the other judges made it known that they approved of the separate opinion.[15]

When the Supreme Court stated that the key question in tax avoidance cases is whether the court must approve of the tax avoidance, it gave rise to a reasonable apprehension in the minds of taxpayers that the legal rights and duties flowing out of their contractual relationships might well be ignored by the revenue (with the support of the courts) if the courts believed the contracts did not deserve judicial benediction. Quite in what circumstances such a judicial benediction would be forthcoming was not spelt out in *McDowell*.

What was more worrying was that Justice Chinnappa Reddy, in describing the judicial attitude towards tax avoidance, made it clear that the *Westminster* doctrine is a dead letter law as far as Indian jurisprudence was concerned. He stated that "in the very country of its birth, the principle of *Westminster* has been given a decent burial" and that "no man now can get away with a tax avoidance project with the mere statement that there is nothing illegal about it".[16] The *Westminster* doctrine was widely seen in the tax advice industry as blessing legitimate attempts to reduce one's tax liability within the four corners of the law. Therefore a judicial pronouncement sounding the death knell of the *Westminster* doctrine, combined with the wide amplitude given in Justice Chinnappa Reddy's judgement to attack tax avoidance measures, led to much anxiety among tax advisers, and raised fears of the judicially determined status of commercial transactions completely overshadowing the contractual intentions of the parties to the transactions.

This was, needless to say, a very unsatisfactory state of affairs (for tax lawyers), which was fortunately remedied to some extent in *Union of India v Azadi Bachao Andolan (ABA).*[17] In *ABA*, the petitioners were a civil society group that petitioned the Supreme Court to prevent what they felt was a national outrage: the India-Mauritius Double Taxation Avoidance Agreement ("DTAA") was being used to reduce taxes owed legitimately to the Indian government. The immediate provocation for the petition was a circular issued by the revenue that clarified that in order to obtain any treaty benefits under the India-Mauritius DTAA, a residency certification from the relevant Mauritius authority was sufficient. This circular

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14 *Ibid* at 809.
15 *Ibid* at 824.
16 *Ibid* at 807.
17 2003 Indlaw SC 823 [*ABA*].

raised the hackles of the petitioners because obtaining a residency certificate without also having a substantial physical presence in Mauritius was possible. The petitioners claimed that the circular was going to be used as a tax avoidance mechanism to obtain the benefits of the India-Mauritius DTAA without having any real presence in Mauritius.

In an argument directly relying on the Supreme Court's comments in *McDowell*, the petitioners claimed that "any tax planning which is intended to and results in avoidance of tax must be struck down by the Court."[18] This argument, if accepted by the court, would sound the death knell for tax planning and confirm the absolute and permanent suzerainty of status over contract. Fortunately for investors and their financial advisers, the Supreme Court refused to extend *McDowell* in the manner asked for by the petitioners.

The Supreme Court stated that it would not endorse the "extreme view" of Justice Chinnappa Reddy, which was to cast doubt on any transaction intended to avoid tax.[19] The Supreme Court denied that the *Westminster* doctrine was not valid anymore, as Justice Reddy had asserted. The *ABA* judgement went through the corpus of English judgements post *Westminster* and concluded that the *Westminster* principle continued to hold ground in English law.[20] The *ABA* judgement concluded that tax planning which is otherwise valid in law cannot be treated as "*non est*" because the scheme adopted by the taxpayer had some underlying tax avoidance motive.[21]

Apart from granting benediction to tax planning (not tax abuse), the *ABA* judgement is also noteworthy for its approach to the interpretation of double tax treaties. The Supreme Court made a sharp distinction between domestic legislation and tax treaties.[22] It characterised tax treaties as products of commercial negotiations and diplomacy between nations, intended for a number of reasons that go beyond an allocation of tax revenue between the treaty partners.[23] Developing countries frequently make use of tax treaties that allow treaty shopping in order to attract much needed capital and technology. In this respect, the role of tax treaties is similar to the role of tax holidays or other tax incentives in attraction foreign investment.[24]

Given this characterisation of the nature of tax treaties, the Supreme Court was less inclined to treat the idea of post box companies (as one example of treaty shopping) as alarming. It pointed out that Mauritius has been considered as a conduit for foreign investment in India and in fact the Indian government would not have been unaware of the tax benefits that accrued to the residents of Mauritius because of the India Mauritius tax treaty.[25] India intended to and did indeed derive significant economic benefits from the treaty and therefore an interpretation of the treaty provisions must keep this larger commercial picture in mind. To sum, the Supreme Court made it clear that given the commercial context of the tax treaty, it would not interpret the provisions to require the putative residents to provide anything beyond what the plain meaning of the treaty required in order to prove their residential status.

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18 *Ibid* at para 139.
19 *Ibid* at para 144.
20 *Ibid* at paras 143-163.
21 *Ibid* at para 164.
22 *Ibid* at para 133.
23 *Ibid* at paras 134, 135.
24 *Ibid* at para 136.

ABA established firmly the primacy of contracts in international taxation. Taxpayers could not get away with sham transactions but barring such instances, taxpayers could fashion their transactions any which way they wanted in order to reduce their tax liabilities. In the international tax arena, *ABA* was not an outlier. Multinational corporations have long taken advantage of the primacy of contracts to reduce their international tax liability.

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[25] *Ibid* at para 138, where the Supreme Court stated "[d]espite the sound and fury of the respondents over the so called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into."