PROPOSED ANTI AVOIDANCE RULES IN INDIAN DIRECT TAX CODE REGIME: A FAILED INTERNATIONAL CONCEPT BEQUEATHED IN ORDER TO PUT AN END ON TAX EVASION

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Vinayak Gupta* and Sagnik Chatterjee†

ABSTRACT

Tax is like a fictional character ‘Robinhood’ which takes money from the riches to serve the public purpose. However the purpose of this inanimate Robinhood fails when the mask of corporate personality is used to evade and avoid taxes with an angle of international transaction. In a developing country like India, the research scholars are really concerned on the issue of low tax base and tax revenue. On the top of it international transactions and use of tax havens by the private players in the mask of corporate entity takes away the share of Indian revenue and hence hampers development. It is always hoped in such situations that new legislations like Direct Tax Code [hereinafter referred as DTC] will change this history and generate good tax revenue for development. On contrary to it and in search for good tax revenue, the DTC is coming up with a bonanza but matter of concern is that its provision with regard to the instant issue is against the fiscal jurisprudence. The DTC draft is adding salt to this injury by using ambiguous terms. The suggested DTC provisions are not a first time experiment across the globe. The Authors in the course of this paper have discovered the failing aspect of such provisions across the globe. This seriously calls for trouble for a newly budding Indian Economy. Conclusively and in precise, the paper tries to find out whether the ambiguous DTC being against fiscal jurisprudence; fundamental difference of tax evasion and tax avoidance; concept of residence for taxation and international failure of similar provisions will hold some relevance for India.

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“Taxes are what we pay for civilized nations”

Oliver Wendell Holmes

The term “tax” reminds of a famous fiction character Robin Hood who used to loot the riches to help out the poor. In a similar fashion, the government levies taxes on riches or taxable persons with a Robin Hood like intention of national welfare and public interest. However it is a bitter reality that human nature is self centric as highlighted by Hobbes in his social contract theory. Hence he hesitates from sacrificing a share of his income. This self centric nature of human being leads him to use the mask of corporate personality for evading taxes. The tax payer should understand that they had an onus as a tax payer to pay fair share for the development. Now the question arises who will decide what fair share is and how it will be decided. However revenue department cannot let these activities go free and let the rich become richer because the fair share is hard to define. Hence the legislatures made so many amendments every year to match up with the pace of time. This paper primarily focuses whether the arrival of DTC will be able to stop tax payers running away from the sword of tax. With an eye to get the answer of these questions, this paper is classified into five parts. Part I of the paper explains the key terms and points out the loopholes in the contemporary provisions. Part II explains that how these loopholes are being utilized for saving from the sword of tax. Part III reveals the hollowness of the highly awaited DTC. Part IV being culmination point of the essay tries to answer the mentioned question.

1 Oliver Wendell Holmes, Jr., spoke this in the case of Compania General deTabacos de Filipinas v. Collector of Internal Revenue, 1904.
1. CONCEPTUALISING THE CONTEMPORARY PROVISIONS OF LAW WITH REGARD TO PIERCING THE CORPORATE VEIL IN TAXATION MATTERS

In this part of the paper, the key terms involved in the title of the paper will be briefly discussed with emphasis on point out the loopholes in the contemporary scenario. The terms like Corporate veil, Lifting of the Corporate veil and International Transaction is deeply analyzed to portray the current picture of legal framework.

1.1. Evolution of Concept of Corporate veil: A foundationally weak concept

“Company has its own corporate personality. It can be sued and it can sue.”

It is a well acquainted line of the Corporate world and in fact foundation of it. The concept of corporate veil evolved in the fate deciding verdict of Common Law Corporate history delivered by House of Lords in *Salomon v. Salomon*[^2]. It is matter of surprise that the foundation laying judgement is itself an epitome of criticism even after two centuries.

1.1.1. Ratio of the case

In this case, The House of Lord absolved Salmon from the debts because of separate corporate personality of the company. The ratio that came out of the judgment was that the company and subscribers are two different persons. The difference between the two, subsequently, kept on being referred to as the corporate veil. The doctrine is a historical milestone from the perspective of company law. But it is equivalently criticised by the eminent legal persons.

1.1.2. Controversies related to the case

1.1.2.1. Legal Criticism of the decision

The agency argument was first time raised in the case of *Broderip v. Salomon*\(^3\) and the court preferred the alternative of treating the company as an agent.\(^4\) The House of Lord got a chance to amend this decision in the form of an appeal and lay down the foundation of the concept of Corporate Veil. The concept of the separate corporate personality was finally laid down but it soon witnessed the counter argument of Agency which arrived as an accepted ground for lifting the veil and ignoring the separate corporate veil. Hence it is in a way a counter to the ratio of *Salomon v. Salomon*\(^5\). Similar is situation with façade ground of lifting the corporate veil.\(^6\)

1.1.2.2. *Contrary to Economic and Law approach*

The Economic and Law approach has been vital to the concept of Company Law. It is to be noted that as per this approach, the company is nothing else but the web of the contracts between various shareholders.\(^7\) Hence the contract should not provide a separate legal personality to the contracting party. However the view of the judgement was totally contrary to it and hence became a point of criticism.

1.2. *lifting of the Corporate veil*

The circumstances under which the courts may lift the corporate veil may broadly be grouped under the following two heads:-

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\(^3\) *Broderip v. Salomon*, [1893] B 4793.

\(^4\) *Id.*, at 347.

\(^5\) *Salomon v. Salomon*, supra note 1.


• Under statutory provisions.
• Under judicial interpretations. (hereinafter referred as Common Law Grounds)

The lifting of the corporate veil can be classified into peeping, extending, ignoring and penetrating.

The first category of lifting the veil i.e. penetrating is more operative with regard to the shareholders. The courts reach through the veil and grasp the controlling shareholders personally. The veil is lifted only to get information regarding the persons who control the company, such as who the shareholders are and the proportion of their holdings. Their inter-relationship with regards to the control of the company, is referred to as peeping. A third technique of lifting the veil is by its extension so that it embraces a bunch of companies together. The most extreme form of lifting the veil is when the courts ignore it completely. This approach is as a sanction to which the courts turn when they think that the company was not founded for commercial or other sound grounds, but only as a means to defraud or defeat creditors or to circumvent laws. While talking about the tax laws, only peeping and extending are relevant. The example of peeping in the instant Income Tax Act, 1961 is where any private company is wound up and if tax arrears of the company in respect of any income of any previous year cannot be recovered, every person who was director of the company at any time during the relevant previous year shall be jointly and severally liable for payment of tax. On the other hand the example of instances in transfer pricing is extending the veil. However lot more such provisions has entered into tax laws with the arrival of DTC.

1.2.1. Common Law ground of lifting the Corporate veil in taxation matters

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8 See also S. Ottolenghi, From Peeping behind the Corporate Veil, to Ignoring it Completely, 53 MOD. L. REV. 338, (1990).
“And…there went a decree….that all the world should be taxed”

- Luke 2:1 (king James)

It’s not always so easy to use corporate personality for escaping or reducing liability as in the above cited case of Salomon v. Salomon. Sometimes this trick of reducing liability attacks back in the form of boomerang and corporate veil is lifted for taxing the real personality. Whenever a legal corporate personality tries to evade tax or circumvent the tax obligation then the veil is lifted for the purpose of taxation. A classical example of this is Re FG Films where a subsidiary company was created for the distribution and presentation of an American picture in a manner that tax can be evaded and hence the veil was lifted. The above mentioned English ratio was also followed in leading Indian case of similar factual matrix Re Sir Dinshaw Maneckjee Petit the assessee formed four private companies and transferred his investments to each of these companies in exchange of their shares. The dividends and interest income received by the company was handed back to Sir Dinshaw as a pretended loan and hence the veil was lifted. When a prima facie look is put on the factual matrix of the complex modern cases of McDowell v. CTO, Azadi Bachao Andolan, Vodafone, Gracemac etc., it is justified to comment that

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9 Salomon v. Salomon, supra note 1.


11 Re FG Films, ibid.

12 Re Sir Dinshaw Maneckjee Petit, AIR 1927 Bom. 371.


16 Gracemac Co. v. ADIT, 2010 Indlaw ITAT 163.
these are just a form of old wine seen in *Re FG Films*¹⁷ etc. in a new bottle of international transactions. Now, the veil in the taxation matters is lifted when the corporate vehicle is being used for tax evasion or circumventing tax obligation. However it did not affect avoidance of tax. Hence it is essential to understand of the thin line of difference between tax evasion and tax avoidance.

1.2.1.1. **Tax Evasion and Tax Avoidance: Conceptual Analysis**

“If someone were to write a full history of taxation, including both practitioners’ experience and the thinking of theorists, it is probably a good guess that tax evasion would be part of the picture from the very start.”

-Agnar Sandmo¹⁸

It is settled fact on the earth that both tax avoidance and tax evasion are the escapist route to save the income from the sword of tax. However in the fiscal jurisprudence, the former is referred as legitimate where as latter amounts to the breaking of law. The conceptual distinction between tax evasion and tax avoidance hinges on the legality of the taxpayer’s actions. In tax avoidance, assessee enjoy the benefit of loopholes in tax legislations; for instance, to convert my income arriving from territorial area of India to income from Special Economic Zone. On the other hand, in tax evasion, there is the violation of laws. When the taxpayer refrains from reporting income from labour or capital which is in principle taxable, he engages in an illegal activity that makes him liable to administrative or legal action from the authorities. However it is very hard to notice a difference between the two concepts at times and the court also gets into this problem when it is required to deal with these concepts. This dilemma exists throughout the world and hence law

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¹⁷ *Re FG Films*, supra note 12.

regarding lifting the corporate veil in the matter of taxation goes under randomization everywhere. This will be explained further in the next section of the paper with several examples.

1.2.1.2. Reaching upto the root cause of tax avoidance and evasion in India

“To the biggest question of the present day, the answer lies in the history book.”

In a developing economy, development of country is the first priority which seeks a huge sacrifice in the form of tax.\(^{19}\) However it is not so easy to collect taxes in a developing country because of a lot of economical problems through which its taxpayers go through. This curse become worse for these economies when its people earning out of it refuse to pay tax by circumventing their obligation to do so. The development in India is also affected by this scenario.

In the early period of Indian democracy, the taxation policy was totally ruined and the vision of India or primarily Nehru was based on Russian model of establishing heavy industrial PSUs. To bring the development of India into mainstream, T.T. Karamchari, then Finance Minister of India, introduced taxes at a total rate of 87.5%. Even, J.R.D. Tata conceded in a private conversation with Gurcharan Das in his book that he used to pay more than 100% tax.\(^{20}\) This basically rooted the use of international transaction to evade, avoid or circumvent the tax in India. Aditya Birla, a noted Indian industrialist who was the chairman of the Aditya Birla Group of Industries, also used the international route for circumventing tax and rigidity of license raj. Aditya Birla inaugurated several companies outside Indian peninsular mostly in eastern Asia.


These companies stood out of Indian Capital. This kind of taxation and fiscal policy basically opened up path for a parallel economy in India with a lot of tax evasion and avoidance. India entered into the Liberalisation era in 1991 under the guidance of P.V. Narshima Rao, then Prime Minister of India. However the problem of harshness of tax rates did not get over with the starting of Liberalisation era. It could be easily noted in the present scenario with the help of given illustration.

**ILLUSTRATION**

If ‘A’ is indulged in manufacturing and selling of Textile, then firstly he will be charged the Professional tax. As he is also engaged in selling of the textile he will also be charged the Sales tax. For importing the goods he will be charged Central Sales Tax, Customs Duty and Octroi. As he gets an income by selling the goods he should pay Income Tax. As the textile will be manufactured in the factory Excise Duty should be paid. ‘A’ shall also pay Municipal tax for having a Factory/Warehouse/ office. When ‘A’ has a good turnover he shall pay the Turnover tax and if otherwise he shall pay the Minimum Alternative Tax. For the business purposes if A withdraws more than permitted amount from the bank then he will have to pay the Cash Handling Tax. If he takes or gives any of these services then he has to pay a Service tax. When ‘A’ goes out of station for business he has to pay the Fringe Benefit Tax. As ‘A’ is accumulating wealth from his business he shall also pay the Wealth tax.

By paying so many kinds of taxes, a trader gets discouraged to start a business. However businessmen are well aware of the fact that India has a great market for their products and hence they try to sell through the International route. In the end, this leads to the loss of Indian revenue. It was contemplated that the introduction of DTC and GST shall eliminate such and consolidate
the Indian taxation laws. However it will be seen in the latter parts of the paper that the DTC suggests arrival of the contrary situation.

1.2.1.3. **Compiled Analysis of the Defects in the arena of piercing the Corporate veil in the matter of taxation: An analysis through Case Study methods**

“In summation…the doctrine of the Corporate entity…plays an important role in the tax field, the flexibility with which it is applied by the Courts has left many doubts as to how it will be applied to any particular case”21

These lines written by the eminent American jurist, Mertens, more than half a decade ago, still holds the veracity in most of the common law jurisdictions. Within the ambit of this section of the paper, the inconsistency leading to the doubts as arriving in the series of the cases is easily visible through the below analysis of UK and India.

1.2.1.3.1. **UK**

1.2.1.3.1.1. **Factual Scenario of Selected precedents concerned with this issue**


The Duke of Westminster used to pay his Gardner $3 as his salary. To circumvent taxation, he started paying him in equivalent material form.

W. T. Ramsay Ltd., a farming company made a handsome capital gain and was trying to hide it under the garb of a complex and self-cancelling transactions which had generated a loss on the account sheet.

There was Company A and Company B owned by father and son separately. They were doing intra-company transaction in shares to avoid capital gains.

The taxpayers exchanged their shares in a trading company (Q Ltd) for shares in an Isle of Man holding company (M Ltd), in anticipation of a potential sale or merger of the business. Meanwhile, the taxpayers had abandoned negotiations with one interested party, and later concluded a sale of Q Ltd's shares with another. M Ltd subsequently loaned the entire sale proceeds to the taxpayers, who appealed against assessments to capital gains tax.

1.2.1.3.1.2. **Judgments/Ruling of the Courts on this issue**

<table>
<thead>
<tr>
<th>IRC</th>
<th>W. T. Ramsay</th>
<th>Furniss</th>
<th>Craven v. White</th>
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<tr>
<th>v. Westminster(^{26})</th>
<th>v. Inland Revenue Commissioners(^{27})</th>
<th>v. Dawson(^{28})</th>
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<tbody>
<tr>
<td>The House of Lord considered it as a legitimate tax planning and hence held non-taxable</td>
<td>The Appeals Chamber decided to consider the whole transaction as a whole and hence considered its gain to be taxed. This decision is considered in UK to be a departure from Westminster principle as the purpose of both the transaction is to carry out existing model but with an access for rescue gate of tax.</td>
<td>The Ramsay principle got strengthened by this judgment. It was held that transaction has pre-arranged artificial steps which serve no commercial purpose other than to save tax and hence they decided to tax whole transaction.</td>
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</table>

It laid down that the Furniss v. Dawson was applicable only on pre-ordained transaction entered with the purpose of tax avoidance. Hence the doctrine being non-applicable, it found this transaction as tax planning

1.2.1.3.1.3. **Conclusive Remarks**


\(^{29}\) Craven v. White, *supra* note 25.
These cases may look like a series of orderly arranged judgments after the arrival of Craven v. White. But it is not so. The judgment of Craven v. White also had a big dissenting voice involved in the favour of application of Ramsay principle. Moreover, Westminster Principle and Ramsay principle is also based on more or less similar facts. Ultimately, this confusion among the tax planning and tax avoidance in the country from where India had taken its legal system as well as this principle is the cause root of problem in India.

1.2.1.3.2. **India**

1.2.1.3.2.1. **Factual Scenario of Selected precedents concerned with this issue**

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<tbody>
<tr>
<td>The excise duty is to be paid by the manufacturer on the removal of liquor from distillery. However the buyers themselves paid the excise duty and they did not include this amount for sales tax.</td>
<td>It was a Public Interest Litigation in which the investment of Indians through Mauritius registered Companies was challenged. The Companies had a tax residency certificate of Mauritius which as per CBDT circular No. 789 is of no value before the court.</td>
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30 Mcdowell v. CTO, supra note 13.


32 Vodafone International Holdings B.V. v. Union of India, supra note 15.
A company holds 100% shares of another non-resident company which in turn held 67% shares in the Indian company Hutchinson-Essar. Hutchinson-Essar was a joint venture between Hutchinson International and Essar. Vodafone International Holdings BV acquired the entire share capital of first company from Hutchison International. This resulted in an indirect transfer of 67% shareholding in Hutchinson-Essar to Vodafone.

The Petitioners, a Cyprus registered company and another company acquired 100% shares in a UK registered which in turn held 51% shares in an Indian company. The Indian tax authorities sought to tax the transaction under the head of capital gains, and sought further information from the parties.

1.2.1.3.2.2. **Judgments/Ruling of the Courts on this issue**

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<tbody>
<tr>
<td>They lifted the corporate veil. However the most notable feature of the judgment is the lines of Justice Reddy where he stated that westminster principle has been buried in its own birth land and what should be referred</td>
<td>The CBDT circular was rejected and veil was not lifted. The Court rejected Justice Reddy’s viewpoint and stated that even in his opinion, tax planning is legitimate. However to state that tax avoidance is</td>
</tr>
</tbody>
</table>

[^2]: Mcdowell v. CTO, supra note 13.
for the demarcation between tax evasion and tax avoidance is not only genuineness of the transaction but also the fiscal purpose of the transaction. Hence the doctrine of Westminster that “given a document of transaction is genuine the court cannot go behind it to some supposed underlying substance” is challenged in India.

<table>
<thead>
<tr>
<th>3. Vodafone International Holding BV v. Union of India(^{36})</th>
<th>4. Richter Holding v. ADIT(^{37})</th>
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<tbody>
<tr>
<td>Though decision of Vodafone case is not about corporate veil. Vodafone Case does not favour the revenue when it comes to imposition of tax by the Indian authorities on sale of shares in an offshore company that has a substantial stake in an Indian subsidiary company by lifting the corporate veil.</td>
<td>This judgment is one step ahead of Vodafone as it specifically justified lifting the corporate veil for taxation of similar transaction. It is observed that to know the real nature of transaction is very necessary to lift the veil. The lifting of the corporate veil depends upon the question that whether the petitioner, as a majority share holder, enjoys the power by way of interest and capital gains in the assets of the company.</td>
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</table>

\(^{36}\) Vodafone International Holdings B.V. v. Union of India, *supra* note 15.

and whether transfer of shares in the case on hand includes indirect transfer of assets and interest in the company.

1.2.1.3.2.3. Conclusive Remarks

It is easily visible that our law on the point of tax evasion and tax avoidance is flimsy. In a recent development the Supreme Court rejected the review petition of Vodafone, however, the Budget for the year 2012-13 has given the power to the taxman to tax retrospectively, which in effect has the power to over ride the much talked about Vodafone ruling.\(^{38}\)

1.2.2. Other Common Law Doctrinal Grounds used for lifting the Corporate veil in the matter related to taxation: A bird’s eye view

1.2.2.1. Factual Agency Argument

Usually the concept of agency is used as an example of a circumstance in which the courts will lift the corporate veil, in reality, to label an entity as part of an agency relationship. In any given circumstance, if an agency relationship is found to exist between the holding company and its subsidiary, the holding company will be responsible and liable for the actions of its agent, providing the agent acts with the authority of its principal. The litmus test for lifting the corporate veil on this ground is “whether it is reasonable to assume that transactions entered into by the company were entered on behalf of one individual/another company”\(^{39}\). It is pertinent to note that this test is heavily subjected to the degree of judicial subjectivity. This is a ground

\(^{38}\) Budget 2012 has made retrospective amendments to Sec 2(14), Sec 2(47) and Sec 9 of the Income Tax Act.

\(^{39}\) New Horizon Ltd. v. UOI, 1995 SCC (1) 47.
consistently acceptable both in India\textsuperscript{40} as well as England\textsuperscript{41}. This could also be used for lifting the corporate veil in the matters of taxation when a person has created an agent to save tax.

1.2.2.2. \textit{Façade or Sham Argument}

It is taken as a ground when a company is being used as mask for working in the market or day to day transaction or for taxation purpose or any other such purpose. It is considered as one stable ground for lifting the corporate veil throughout several countries. The classical judgment on this exception is \textit{Adam v. Cape}\textsuperscript{42}. This ground is recently used in Gracemac case\textsuperscript{43} to lift the corporate veil and tax the transaction.

1.2.2.3. \textit{Impropriety}

This ground for exception is popularly known as fraud also. In a number of the recent cases, the courts have considered the principle that the corporate veil can be set aside on the grounds that the company has been used to carry on an unlawful activity or in order to avoid the impact of an order of the court.\textsuperscript{44} This could be also used to give relief in certain taxation matters.

1.3. \textit{International Transaction: A comparative analysis of DTC and IT Act, 1961}

International transaction is defined under Section 92B of the Income Tax Act, 1961. The definition can be divided into two parts i.e. for associated enterprises and other persons. A

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\textsuperscript{40} Novartis v. Adarsh Pharma, 2004 (3) CTC 95.

\textsuperscript{41} Re FG Films, \textit{supra} note 12. See also, Broderip v. Salomon, \textit{supra} note 2.

\textsuperscript{42} Adams v. Cape, [1990] Ch 433.

\textsuperscript{43} Gracemac Co. v. ADIT, \textit{supra} note 16.

\textsuperscript{44} PAUL L. DAVIES & L.C.B. GOWER, GOWER’S PRINCIPLES OF MODERN COMPANY LAW 206 (Sweet & Maxwell, 1997).
transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises will be an international transaction.\footnote{The Income Tax Act, 1961, § 92B.} It also includes a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.\footnote{Ibid.} In case of other persons there should be a prior agreement in relation to the relevant transaction between them or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.\footnote{Ibid.}

Now, Direct Tax code puts a new definition for it. However it could be only referred as the old wine in new bottle. However it is more structured and bit broader in aspect. In DTC, 2010 in case of two or more associated enterprises, it is to be noted that it is referred as international transaction when:-

i. Either or all of them are non-residents

ii. A. purchase, sale or lease of tangible or intangible property or
B. supply of service
C. lending or borrowing money
D. any other transaction having effect on the income, loss or gain of one of them

\footnote{Ibid.}
E. Any mutual agreement between them for allocation, appointment or contribution or expense incurred, or to be incurred, in connection with a benefit, service or facility provided, or to be provided, to any one of them or more

In case of two persons, not being associated enterprise,

i. Either or both of them are non-resident

ii. The transaction is purchase, sale or lease of tangible or intangible property and

iii. There is existence of a prior agreement in relation to the relevant transaction between them or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Note: these three conditions are to be fulfilled together and then only transaction is termed as international transaction.

Section 92A of IT Act and Section 124(5) of the act remains unchanged. These two provisions are very exhaustive and majorly focus on control, management and relation of the company.

2. **INTERNATIONAL TRANSACTIONS FROM THE EYE OF RUNNING AWAY FROM THE SWORD OF TAX**

In this part of the paper, some of the methods of the tax evasion through international transactions are explained so that the problem could be understood in a simple manner. Beyond that taxpayers also try to use tax havens for converting their taxable income to zero.

2.1. *Methods of tax evasion through international transactions*

2.1.1. **Transfer Pricing**

Transfer pricing refers to the intra group transaction implying that two intra-group companies should deal at arm’s length price. Its purpose is to rate the transaction between two intra-group companies at a fair price. Mostly companies try to avoid tax in the garb of such arm’s length
price by effecting the price at which a non-intra group company might have done the same transaction. In modern days, the big multinationals avoid a lot of tax by flexibly changing the rate of services or technology considering the rate of taxes in the two jurisdictions. The below figure suggests two types of tax evasion through it.

2.1.2. Fee and Royalty Adjustments

To tax companies in India, it is needed that the company should have a permanent establishment in India. However the income from fees and royalties in a global economy can be done in a manner of adjusting with a full proof model. By the virtue of this, companies run away from the
liability with a handsome income. A recent example of it is *Gracemac* case\(^{48}\) where company altered their business model of software distribution to save their liability of taxes on the royalty and fees coming out of Indian customers for software. The business model adapted by the Company is a wonderful example of using a tax heaven for the purpose of tax evasion. The new business model of the company is as follows:-

![Figure III](image)

Now, the company was earning out of Indian end users in the new distribution model but was not paying tax on royalty to India by exploiting the fact that it does not have an establishment in India. This irony and flaw of our revenue system is proving advantageous to several such assesses. However ITAT tried to do its part in light of justice by taxing them on the basis of Article 12 of India-US DTA.

**2.1.3. leading and lagging**

\(^{48}\) *Gracemac Co. v. ADIT*, *supra* note 16.
The associated companies also transact in monetary terms. In that case, such companies also consider foreign exchange currency rates. For example: If a subsidiary has to make a payment to the parent firm, in a currency that’s expected to depreciate, the subsidiary can pay in advance (lead the payment) and pay more after the currency depreciates. By paying more after the depreciation of currency, the company legally passes over some of its profits to the parent firm and thereby pays less tax in the source country. Similarly, one can lag payments if the payment currency is expected to appreciate.

2.1.4. Intercompany Loans

Inter Company loans had become a very good method to save the taxes. The Associated companies used to give loans to subsidiary or other associated company for the purpose of funding and show it as a debt and charge interest higher than the arm’s length. An example of it is given below:-

![Diagram showing intercompany loan](image)

**Figure IV**

2.1.5. Dividend adjustment and investing in the form of debt and equity.

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Sometimes a company owned or controlled by Indians do not pay for their incomes earned and distributed to Indians by establishing a below mentioned model. For example: Indians with a fifty percent ownership in a company establishes its foreign subsidiary in Mauritius which further controls a company in America. Now, American companies distribute profits out of the dividend which is received by the Mauritian Company. Now, with an intention to have tax benefit, the Mauritian Company parks its dividend and invests as per the directions given by the Indian owners. In this manner, Indian company gets a tax free share in Income rescuing its liability.

2.2. **Tax Havens: A Escapist Route**

“The house painter who does a bit of extra work in the black economy violates the law, while the wealthy investor who engages a tax lawyer to look for tax havens does not.”

*Agnar Sandmo*\(^50\)

2.2.1. **Concept Analysis**

Different jurisdictions have different rates of taxes. A tax haven is a country or a territory where certain taxes are levied at a low rate or there is no tax liability to foreign individuals and corporate entities. Individuals and corporate entities find it attractive to move themselves to areas with reduced or nil taxation levels as it helps them in saving their revenue. This creates a situation of tax competition among governments. For taking benefit of it, tax payers open a company in these countries to reduce their burden.

The Organisation for Economic Co-operation and Development (hereinafter referred as OECD) identifies four key factors in considering whether a jurisdiction is a tax haven or not:

\(^{50}\) *Agnar Sandmo, supra* note 18.
• The first is that the jurisdiction imposes no or only nominal taxes.

The OECD doesn’t consider the ‘no or nominal tax criterion’ to be sufficient by itself, to result in characterization as a tax haven.

• Whether there is a lack of transparency

Among the similarly situated taxpayers, the transparency ensures that there is an open and consistent application of tax laws.

• Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation.

The OECD encourages countries to adopt information exchange on an “upon request” basis. Exchange of information upon request describes a situation where a competent authority of one country asks the competent authority of another country for specific information in connection with a specific tax inquiry, generally under the authority of a bilateral exchange arrangement between the two countries.\(^5\) It ensures implementation of appropriate safeguards for adequate protection of taxpayers’ rights and the confidentiality of their tax affairs.

• Whether there is an absence of a requirement that the activity be substantial

The no substantial activities criterion was included in the 1998 Report simply because of the fact that a jurisdiction may be attempting to attract investment and transactions that are purely tax

driven. In 2001, the OECD’s Committee on Fiscal Affairs agreed that this criterion would not be used to determine whether a tax haven was co-operative or non co-operative.\(^{52}\)

### 2.2.2. An analysis of Leading Tax heavens proving tax funnel for India

#### 2.2.2.1. Mauritius

An active use of it is also noticed in public interest litigation of Azadi Baachao Andolan\(^ {53} \). A major reason behind its use as tax heaven is India-Mauritius DTAA which these days is being actively used for tax planning. Under the India-Mauritius DTAA, there is no capital gains tax in either India or Mauritius on the sale of the shares of the Indian company by a Mauritian company.\(^ {54} \) Hence a company registered there and not having PE in India will not be taxed in India or Mauritius. The dividends received from an Indian company are not taxed at either of the places, if the Mauritian entity owns more than 5 per cent of that company. Where the ownership is less than 5 per cent, it is generally possible to reduce the 3 per cent Mauritius income tax to effectively zero. The innovative and tax efficient legal framework coupled with a stable political climate makes Mauritius a perfect place to route investments to India.\(^ {55} \)

#### 2.2.2.2. Singapore

Singapore is also an attractive option for the investment route in India. In Singapore-India DTAA Singapore residents are not to be taxed for capital gains in India. Moreover Singapore

\(^{52}\) *Ibid.*


\(^{54}\) Convention between the government of the Republic of India and the government of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes of income and capital gains, Notification F. No. 501/20/73-FTD (6 Dec.,1983) § 11, 13.

\(^{55}\) Anjali Agarwal, *Inbound investments into India - structuring the deal!*, 24(7) J.I.B.L.R. 375, 377 (2009). (hereinafter referred as Anjali)
also does not tax capital gains if they are not from trading activities. Under the India-Singapore DTAA, interest payments received in Singapore from an Indian company to a Singapore tax resident would be subject to withholding tax of 15 per cent. Dividends distributed by Indian company will be exempt in the hands of the shareholders subject to payment of dividend distribution tax by the Indian company at the time of distribution of the dividend. Only ray of positive hope is that these lucrative benefits of Singapore are not available for taxing shell corporate personalities.

2.2.2.3. **Cyprus**

Similar to above jurisdictions, under India-Cyprus DTAA, the Cyprus resident companies are not taxed for capital gains on sale of shares and dividends out of it. Hence it is developing as a lucrative alternative to the above tax havens. However, in order to benefit from the India-Cyprus DTAA, the Cyprus company must be the beneficial owner of the relevant asset from which the revenue is derived and must be a tax resident of Cyprus, which under the India-Cyprus DTAA means a person who is liable to pay tax in Cyprus by reason of domicile, residence, place of management or other similar criterion.\(^{56}\)

2.2.3. **Conclusive remarks**

The purpose of DTAA is to avoid double tax. However in the case of these tax heavens, it has been converted into a device which takes out maximum benefit by the way of treaty shopping.

3. **DIRECT TAX CODE AND CORPORATE VEIL: WILL IT CREATE A NEW ERA?**

3.1. **GAAR**

3.1.1. Need of GAAR

In the initial stage of the paper, it was put forward that a fair share of tax should be paid by a person irrespective of the fact that tax avoidance and planning is legitimate. Now, the provision of GAAR is not to discourage tax planning but it is to set a level of tax planning so that fair share should be paid by the assessee. GAAR not only helps in setting a fair share but also serves an important role in context of the applicability of the canon of taxation i.e. equity. In taxation, when an assessee tries to avoid tax, it puts an extra tax burden on other equal tax payers and hence spread inequitableness. Summing up and substantiating this line of argument with the following line of the Spanish Constitutional Court:

“what remains unpaid by those who should have paid it, will eventually have to be paid by other citizens that are either more law abiding or have less practical possibilities to avoid taxes”.

3.1.2. Conceptual Analysis of GAAR in DTC

The DTC contemplates inserting a General Anti-Avoidance Rule in the Indian taxation system. As evident from the name that it is a provision to put a check on the avoidance of paying taxes in India. GAAR was a part of DTC from its very draft

3.1.2.1. Provision of GAAR in DTC first draft and Revised discussion paper

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57 Opinion no 76/1990, 26 Aprii (FJ 4)
Figure V

GAAR was given in Section 112 of the first draft of DTC and basically targets to prevent tax avoidance. Now, it is given in Section 123 of DTC, 2010. It empowers commissioner to give notice to any transaction merely for the purpose of tax benefit and put a full stop upon it. The above diagram is helpful in understanding the concept of GAAR in DTC. Four arrows at both sides of the diagram refer to the term “impermissible avoidance arrangement” as defined in Section 124. The circles in the above figure represent the remedy which could be provided in such situation.

3.1.3. Thin Capitalisation Rule under GAAR

As discussed earlier, the companies try to avoid tax with the help of inter-company loans. Under the provision of GAAR, Section 123 has been given power of debt equity conversion. In cases where the company show themselves under debt to hide their income, this solution in Section 123 will prove path-breaking. However a specific section on this issue would be better.

3.1.4. GAAR: A policy anti the basic right to save tax?
As suggested earlier, law permits tax saving through avoidance and only poses problem for tax evasion. However a provision of GAAR puts a partial restriction on avoidance which law permits. Such restrictions are necessary in light of conditions in which taxpayers with utilization of tax haven convert their taxable income to zero. Such dynamical change was also noted in McDowell rule in India. Taking one step ahead, GAAR provides for a more concrete manner to fight against such tax avoidances and planning which are merely done for tax benefits.

3.1.4.1. GAAR: A new confusion cloud

In India, the judiciary generally believes that minimizing the taxable income by all kind of avoidance methods is good in law. This is what we noticed in Azadi Bachao Andolan. Now there is a possibility that this dictum of Azadi Baachao Andolan will not be good anymore with GAAR coming into force. Hence it will create confusion on this legal issue which can even lead to the clash between Apex Court and Legislature in future.

3.1.4.2. Arbitrary GAAR: Experience from the globe

“Occasionally judges cannot resist the temptation to make general comments, often uncomplimentary, about the tax legislation they are called on to interpret.”

“The problem of interpretation comes forth when doors are left open with the use of ambiguous terms.”

Indian GAAR provision has a long list of interpretation with it. However it makes no exception to the global trend and puts forward one more ambiguous provision. An example of it is interpretation of the term “impermissible tax benefit” in Section 123. It defines impermissible tax benefit in Section 124(15) as follows:-

“impermissible avoidance arrangement” means a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit and it—
... (d) is entered into, or carried out, by means, or in a manner, which would not normally be employed for bona fide purposes”

Now it is hard to determine what bona fide purpose is. For the purpose of it, the bona fide is also defined by DTC in Section 124(10) which states as follows:-

“bona fide purpose shall not include any purpose which—
(a) has created rights or obligations that would not normally be created between persons dealing at arm’s length; or
(b) would result, directly or indirectly, in the misuse, or abuse, of the provisions of this Code;”

Now it’s very hard to decide under point (b) that whether an action comes into the ambit of misuse or abuse or taking benefit of the provision. The issue of interpretation is a big problem everywhere and hence there is serious doubt about the creditability of such provisions in India where the debate is still on regarding the basic lacunas in fiscal jurisprudence.

3.1.4.2.1. Lessons from Canada

Similar to our system, Canada also had a GAAR provision but it is undergoing a problem of interpretation. The reason for the interpretation problem lies in not defining the term “abusive”. In India also, as noted above, the problem lies in the fact that a lot of room has been left open for judicial interpretation in terms such as “misuse” or “abuse”. This has been used as ammunition by opponents of GAAR, who argue that the policy of the specific legislation was unclear in Canada Trustco, so that no other outcome could be expected. Canada noticed two conflicting judgments, Canada Trustco and Mathew on the same fact which opened up the


GAAR provision enumerated in Section 245 of the Federal Tax Act which explains GAAR to be a problem.

3.1.4.2.2. Lessons from Australia

In Australia, GAAR is used in the case of tax benefit which is analysed with the help of eight factors. These factors are: the manner in which the scheme was entered into or carried out, the form and substance of the scheme, timing and length of period during which the scheme was carried out, the result that would be achieved apart from Pt IVA, any change in the financial position of the taxpayer and persons connected with him and any other consequence for the taxpayer and such persons and the nature of the said connection. However the Courts in Australia are still not able to apply these tests properly.

3.1.4.2.3. Lessons from New Zealand

New Zealand is also facing a similar problem with respect to its GAAR provisions. A key issue is the thin dividing line between attempting to override a specific statutory purpose through the GAAR, that is gap-filling, which is not permitted, and employing it as a tool to protect the specific legislation from frustration, which is. An example of it is the Peterson v. Commissioner of Inland Revenue where the Privy Council had a case similar to Barclays Mercantile Business Finance Ltd. v. Mawson relating to financial leasing. The strong dissent from Lord Bingham of Cornhill and Lord Scott of Foscote criticised the application by the majority of jurisprudential principles developed in the U.K. context, where there is no GAAR, and was prepared to look at the surrounding circumstances more widely than the majority.

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63 This has been used as ammunition by opponents of a GAAR, who argue that the policy of the specific legislation was unclear in Canada Trustco, so that no other outcome could be expected.

64 Freedman, supra note 58.


3.1.4.3. **Conclusive Remarks**

In light of all these GAAR provisions across the globe, it could be concluded that GAAR has a latent defect with regard to interpretation. Indian statute as noted is specifically weak on this point and hence a misinterpretation is supposed to arrive. These criticisms are countered by the government in RDP by putting the following fetters:

a) issuance of guidelines by Central Board of Direct Taxes
b) invoking GAAR provisions in respect of an arrangement where tax avoidance is beyond a specified threshold limit
c) providing Dispute Resolution Panel for addressing grievances.

However it should not be forgotten that the statute has a high value and hence when ambiguous, it is very hard to improve them by such guidelines. There is a good possibility that these future guidelines/threshold limit/rulings of Dispute Resolution Panel may be similar to objective test in Australia which is unable to stop misinterpretations.

3.2. **SAAR**

A General anti avoidance rule makes every general transaction for the mere purpose of tax benefit as its target. It is like putting a big blanket on a thief to catch him. At the other hand, a tax avoider can also be stopped from it by restricting certain practices of tax avoidance. These are specific methods to stop tax avoidance practices which are referred as Specific Anti-Avoidance Rule or Specific Anti-Abuse Rules. DTC contains some of such rules.

3.2.1. **Transfer Pricing**

As discussed earlier, transfer pricing is a major matter of concern for a developing country like India. To counter it a stringent law on this point was needed. The DTC has tried to achieve it. An analysis of the new law is given below through the comparision chart.
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>penalty for not filing the accountant report and for the non-maintenance of documents</td>
<td>50,000 Rs.</td>
<td>2,00,000 Rs.</td>
</tr>
<tr>
<td>penalty for non-furnishing of documentations has increased</td>
<td>5,000 Rs.</td>
<td>1,00,000 Rs.</td>
</tr>
<tr>
<td>Safe Harbour Rules to determine the Arm’s length Price</td>
<td>No.</td>
<td>Yes, CBDT will specify the level up to which the authorities will permit the cost of goods or services. However there might be problems in the double taxation issue when other country does not accept the price set by authorities. This issue is not touched by DTC.</td>
</tr>
<tr>
<td>Concept of Advance Pricing Agreement(^{67})</td>
<td>No</td>
<td>Yes. This will help in bringing certainty to the price of transfer pricing of transaction.</td>
</tr>
<tr>
<td>Ambit of Associated Enterprise</td>
<td>The ambit is given in Section 92A of DTC, 2011 is merely a copy of the same provision with two small variations. Firstly, the services</td>
<td></td>
</tr>
</tbody>
</table>

\(^{67}\) It is an agreement between CBDT, with the approval of Central Government, and assesses done in advance to fix arm’s length price of any international transaction valid for five consecutive years. The set of the criteria include the method, comparables and appropriate adjustment thereto, critical assumptions about the future events etc.
provided, directly or indirectly, by one enterprise to another enterprise or to persons specified by the other enterprise, and the amount payable and the other conditions relating thereto are influenced by such other enterprise;
Secondly, any specific or distinct location of either of the enterprises as may be prescribed
The latter (to some extent) is contrary to globally accepted meaning of the phrase “associated enterprise” which mandates participation in control, capital or management.\(^68\) It also being a gray area would lead to dispute.
The terms given for intangible property is now not present in

\(^{68}\) *DTC Countdown*, available at www.bmradvisors.com%2Fupload%2Fdocuments%2FDTC%2520Countdown%2520%2520Transfer%2520Pricing%2520in%2520the%2520DTC%2520era1314967353.pdf?ei=f9JpTorkMoavrAfYuIDIBQ&usg=AFQjCNGGjpiCgS_WeOOnSb6P62dwvRRIQw (2 Sept., 2011).
DTC. It will also create a problem in future. The term firm is also replaced by unincorporated corporation which will bring in new interpretation.

3.2.1.1. Criticism

It is to be noted that these provisions of Transfer pricing is not path breaking. As the devil lies in the details, many historical issues such as use of inter-quartile range, multiple year data, residuary methods, etc have not been addressed. Moreover it has also left out several burning issues like marketing intangibles, global cost allocations, royalty payments, guarantee transactions, etc.

3.2.2. Controlled Foreign Corporation Provision

3.2.2.1. Conceptual Analysis of CFC in DTC

As seen above, the company made by Indians will earn and then distribute dividends outside India and hence failing the Indian taxation system. To avoid such tax evasion in international transactions, the DTC put up a provision for Controlled Foreign Corporations (hereinafter referred as CFC). CFC is a corporate entity which conducts business in one jurisdiction but is owned or controlled primarily by the resident taxpayers of another jurisdiction. These masked entities try to evade full tax with the help of investing through the route of tax havens to reduce tax liability to the tune of negligibility. This provision of DTC stands in the contrary to the

\[69\text{Ibid.}\]
decision of *Azadi Bachao Andolan*\(^7^0\) which legitimized such a transaction of shares through Mauritius based company for tax avoidance.

This provision of CFC was not given due place in the 2009 bill, and instead provided for RDP. According to RDP, passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes, shall be deemed to have been distributed. However RDP remains silent on the condition put forward in proposal of control that whether the extent of control should be direct or indirect. In case, it is interoperated in future in wider sense then it will be unjust to put up such an ambiguous law.

As per DTC bill, 2010, the following conditions should be satisfied for establishing that a company is CFC:-

- It is a resident of territory with low rate of tax
- The shares of such company are not tracked on any stock exchange recognized by law of the territory of which the company is resident.
- One or more persons, resident in India, individually or collectively exercise control over the company.
- It is not engaged in any active trade or business.
- The specified income of the company determined in accordance with the provisions of paragraph 4 of the Schedule XX of the DTC should exceed twenty-five Lakh rupees.

The first two conditions are self-explanatory. As noted down in third condition, it is necessary to look on individually or collectively exercise control.

\(^{70}\) *Supra* Note 14.
• A resident held at least 50% of the voting power or capital of CFC.

• An enterprise has the power to secure application of 50% of income or assets of CFC for its benefit.

• An enterprise has the ability to exercise dominant influence.

• Individually or collectively, have, directly or indirectly, sufficient votes to exert a decisive influence in a shareholder meeting of the company.\(^{71}\)

The fourth condition presupposes an active participation of the company in industrial, commercial or financial undertakings through employees or other personnel under it or less than 50% of the company is from dividend, interest, income from house property capital gains etc. as given in Clause 5(e)(ii).

3.2.2.2. Economical Analysis of the policy

It is a logical fact that this provision will bring a lot of tax revenue from such firm by ignoring their corporate veil and residence. However it will prove to be yet another Antitrust legislation for the Indian trader because it will prove a fetter for them trading globally by establishing a subsidiary. At a time when Indian giants like Tatas, Birlas, Reliance etc. are trying to trade globally, this would be a big setback for them as their subsidiaries would be required to pay such tax for sustaining a global existence.

It should be remembered that India is a net importer of capital. However such rules have relevance for the capital-exporting countries as they do not harm their respective economies. India being a net importer of capital, a higher degree of circumspection is required in introducing such rules as though they may not have a material revenue collection impact, but may pose a

\(^{71}\) The Direct Tax Code Bill, 2010, Schedule XX, § 5(b).
great degree of compliance burden/complexity, not necessarily suited to the current growing financial/investment needs of India.\textsuperscript{72}

3.2.2.3. \textit{CFC: An impractical effort}

It is very hard to apply CFC everywhere in the world. It is a well known fact that the financial year varies everywhere. Hence its implementation is a big problem.

3.2.2.4. \textit{Another door for arbitrariness}

This provision also tries to put a lot of terms and their interpretations. However it has left out the jargons which could make the provisions ambiguous and meaningless. In such circumstances, it would be very difficult to find out as to what dominant influence, direct or indirect, and sufficient votes are required to constitute a ‘decisive influence and active participation’ of the company.

3.3. \textit{GAAR or SAAR: Which of the two is better}

If a comparative analysis of both is done, then SAAR would be considered to be more appropriate as it provides the opportunity to sort the problem of not being futuristic by amendments. However, the fact of GAAR being arbitrary cannot be sorted. GAAR has a problem of being arbitrary which is well rooted in every country using it. Hence, to overcome this problem, methods and tests like objective tests were also put forward by the courts and parliamentarians but they failed carrying a burden of huge expectation. On the other hand SAAR offers reduction in litigation and development of economy because it offers a settled position of

Applying the aforementioned logic, countries like UK, Denmark and Mexico prefer SAAR over GAAR.\(^{73}\)

### 3.3.1. Can GAAR work along with SAAR?

India in the provisions of DTC has selected both of them. Hence the million dollar question is whether they can work together. The answer to the question on the basis of international scenario is positive. Many Countries like Germany are trying to work out with both. It is a very big problem to decide which out of them will prevail in a situation of conflict. Most of the countries balance them.\(^{74}\) Some like Germany provides SAAR a preference to GAAR. In India, DTC is silent on this issue and ambit of the SAAR. This creates a huge cloud of confusion. In such scenario, success of these provisions is highly doubtful. It is recommended that India should use German approach as it will get a very good residuary provision in form of GAAR and settled law in form of SAAR.

### 3.3.2. Supportive System for SAAR & GAAR

It has been observed that in any major international transaction, the asessees always try to take the benefit of the Double taxation avoidance agreements. This is usually also addressed as treaty shopping. It becomes more sinful when asessees try to save each and every penny of their income from the sword of taxation by using the route of tax havens such as Mauritius and Cayman Island.


\(^{74}\) *Ibid.*
According to RDP and DTC, 2010, an assessee will be free to opt for either DTAA provisions or DTC, whichever is more beneficial. However DTAA will enjoy preferential status when the Revenue Department invokes GAAR or CFC provisions. As one dirty fish makes the whole pound dirty, the linkage of this provision with ambiguous provisions of GAAR and CFC makes itself bad and a centre point of criticism. Hence it will be providing a good back up to SAAR and GAAR in DTC.

4. CONCLUSION AND RECOMMENDATIONS

In the very beginning of this paper, there was a word regarding the fair share of taxation that should be paid by a tax payer for the development of the country. DTC was burdened with a hope of getting that fair share of the tax from the mouth of giants saving taxes through international transaction. However it fails to do so. The provision regarding GAAR, associated enterprises and CFC are ambiguous and a gateway for arbitrariness. CFC is also going to pose problems to India’s economy. Hence the policy of lifting the veil in DTC prima facie seems to be a framework of positive motive to put a full stop on the abuse of tax saving principles with a bunch of negative implications of ambiguity, future arbitrariness, economic downfall etc. Now the question is whether such a statute is a good enforcement deal considering these negatives. The answer would be surely no because the ambiguity in certain areas of the DTC would destroy its pious objective. Hence a concrete statute should be prepared to remove ambiguity to make the moral obligation of fair share tax a legal and a binding obligation. As it is rightly said that:

“Morality can play only a limited role in fixing tax payer’s liability and [hence it] must be backed up by law.”

75 Benno Torgler & Friedrich Schneider, The impact of tax morale and institutional quality on the shadow economy, 30(2) JOURNAL OF ECONOMIC PSYCHOLOGY 228, 233 (2009).
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