

## Tax Avoidance and Tax Evasion

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### **TAX AVOIDANCE AND TAX EVASION**

While it is true that international business operations are exposed to the risk of being subject to double Taxation, it cannot be gainsaid that such activities provide opportunities for Tax avoidance and Tax Evasion.

### **MEANING OF TAX EVASION AND AVOIDANCE**

Tax Evasion is an illegal attempt to reduce the tax payable by deliberately under-reporting or not reporting taxable incomes or concealing one's true state of affairs from tax authorities. Tax evasion is a criminal offence and if detected is Punishable by Financial Penalties or even by imprisonment on both Tax avoidance Means Preventing or reducing one's tax Liability through manipulations within the framework of existing tax legislation. Tax avoidance, as against tax evasion, is legally permissible and hence a legitimate aim of taxpayers.

Tax avoidance is resorted to through such devices as formation of holding companies to claim artificial deductions, constitution of trust and Family Partnerships, transfer of income earning assets to one's wife and children for fractioning income for tax purposes, investing in provident fund and life insurance policies, and manipulation of capital gains.

Since Tax avoidance has a colour of legality about it clever taxpayers do their best to avoid or keep down tax payments. This may force the government to raise tax rates, making the less clever assesses bear a disproportionate tax burden.

Tax laws in many countries in corporate anti-tax avoidance provisions under which certain incomes are included in an assesses total income, though such incomes legally belong to other persons. For example, in India sections 60 to 65 of income tax Act, 1961, deal with instances where an assessee may attempt to reduce his tax liability either by transferring his assets in favor of his family members or by arranging his sources of income in such a manner that tax incidence falls on others, whereas

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benefit of income, directly or indirectly, is derived by the assessee himself. Thus, income arising to the spouse, minor child, son's wife, son's minor child and certain other persons are clubbed with the assessee's income in certain circumstances. In this regard the Indian income tax law deviates from the general principle that a person can be assessed in respect of his own income.

### **CAUSES OF TAX EVASION**

#### **Level of Tax Rates**

Among the host of causes of tax evasion, the level of tax rates is probably the most crucial. It is widely believed that higher the rate of tax the greater is the tendency to evade taxes. High tax rates make tax evasion more tempting. Tax evaders readily take greater risks if they know that in the event of success the reward is high.

#### **Attitude towards Government and its Laws**

Tax evasion is more in countries where there is general apathy on the part of people towards the government and its laws. People will have less respect for tax laws if they perceive the tax system to be unfair in terms of level of taxation (tax GDP Ratio) and or distribution of tax burden among various classes similarly, there can be a feeling among taxpayers that government is indulging in wasteful expenditure, e.g. digging the roads too often spending excessively on government functionaries, permitting loan waivers, maintaining Perpetually sick public undertakings, and granting unnecessary subsidies in this connection, the Indian tax Reforms committee, 1991, observed, “..there is a widespread feeling among the electorate that there is considerable waste in government expenditure, that there is excess staff and that the tail to teeth ratio is unduly high and with it all, it is generally felt that the public which pays the taxes gets poor service and members of the public are treated often not as masters who pay but as supplicants. ” More over salaried persons envy tax evasion opportunities available to self-employed professionals and retail traders and are tempted to conceal their incomes from non-salary sources.

#### **Lenient Penal Action**

Lenient Penal action in case violation of law is detected also arrears tax evasion tax evasion by politicians and bureaucrats sends wrong signals to the general public that non-compliance is acceptable. A regime of controls Licenses, and shortages also breeds tax evasion and black money.

### **CONSEQUENCES OF TAX EVASION**

The effects of tax evasion on an economy are indeed disastrous:-

1. Tax evasion cuts at the very root of the revenue potential of a tax system and therefore hinders the resource mobilization efforts of a government. Lack of funds may distort implementation of development plans and force a government to resort to deficit financing in case public expenditure is inelastic.
2. Tax evasion may interfere with the declared economic policies of a government of by distorting saving investment patterns and availability of resources to various sectors of the economy. For instance, government may impose credit restrictions to discourage certain activities (e.g. speculation) but money saved through tax evasion may finance and encourage the same activities.

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3. Evasion of tax seriously undermines the equity attribute of a tax system. Honest tax payers, who are obliged to bear disproportionate tax burden, feel demoralised and tempted to join the tax evader camp.
4. Tax evasion leads to the creation of black money which in turn is a menace to the economy in its own way. Tax evasion and black money encourage concentration of economic power in the hands of undesirable groups in the country.
5. Tax evasion eats into the time and energy of tax administration which is obliged to unravel the intricate manipulations of tax dodgers.
6. Tax evasion leads to degradation of social and moral standards. Social abuses like bribery, intimidation, blackmailing, tampering with official records, submitting fake documents etc. all go with tax evasion.

The nexus between tax evasion and black money and its distortion of the redistributive role of tax policy was noted by India's seventh five year plan as follows, "with a sizeable proportion of income and wealth evading Taxation, the redistributive impact of progressive taxation had been severely blunted. A reduction in the scale of black in come generation would improve distribution of income and wealth after taxation. Besides, if the magnitude of tax evasion is significantly reduced, there would be greater volume of tax revenue and a greater volume of public expenditure benefiting the poorer section of the population would become possible."

#### **The Evil of Tax Evasion**

There is no denial of the facts: evasion of tax is rampant, proliferation of black money is vast, parallel economy is creating havoc, there lay ample provisions of tax laws to check evasion and tax machinery has utility failed in putting a check on tax evasion. When I analyses the reasons, I believe (a) there is constant erosion of human values; (b) there is no education of tax laws; (c) no social stigma is attached, on the contrary tax evaders having money power and vast resources get respect in the society; (d) disclosure schemes are frequently announced, practically every fifth year, during the last 45 years, the latest is the Voluntary Disclosure of Income Scheme, 1997, surpassing all the past Schemes giving a golden opportunity to tax evaders to convert black money to white on nominal and substantially reduced tax; (e) there lay provisions conferring discretion and power to reduce, waive or not to levy interest, penalty or prosecute etc.; (f) innumerable deductions, reliefs, incentives and exemptions providing a tool to reduce effective rate of tax; (g) wasteful expenditure at Government level; and (h) no accountability for the tax administration. It is high time that ways and means to stop evasion of tax are evolved and effective measures are taken.

#### **Avoidance of Income-Tax by Transactions Resulting In Transfer of Income to Non-Residents**

- (1) Section 93 (1) provides that where there is a transfer of assets, by virtue or in consequence where off, either alone or conjunction with associated operations, any income become payable to a non-resident or to a not ordinarily resident person, the following provisions will apply-
- (a) Where any person has be means of any such transfer, either alone or in conjunction with associated operations, acquired any rights by virtue of which he has the power to enjoy. Whether forth with or in future, the income of the non-resident or not ordinarily resident person which if it were the income of the resident, would be chargeable to

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- income-tax, that income shall be deemed to be income of the first mentioned person for all purposes of the Act.
- (b) Where the resident person receives or is entitled to receive any capital sum the payment of which is connected with the transfer or any associated operations then such income which has become the income of the non-resident or a not ordinarily resident shall be deemed to be the income of the resident.
- (2) Section 93 (2) is intended to avoid double taxation and provides that there an assessee has been charged to income-tax on any income deemed to be his income under this section and that income is subsequently received by him, whether as income or in any other form, it shall not again attract tax in his hands at the time of such receipt.
- (3) Section 93 (3) provides that the provisions of this section shall not apply if the resident satisfies the income-tax officer that
- (a) Neither the transfer nor any associated operation was for the purpose of the avoidance of liability to taxation or
- (b) The transfer and all associated operations were bonafide commercial transactions and were not designed for the purpose of avoiding liability to taxation.
- (4) The explanation to section 93 (3) provides that
- (a) references to assets representing any assets, income or accumulations of income include references to shares in or obligation of any company to which, or obligation of any other person to whom, those assets, that income or those accumulations are or have been transferred;
- (b) Anybody corporate incorporated outside India shall be treated as if it were a non-resident;
- (c) A person shall be deemed to have power to enjoy the income of a non-resident if –
- (i) The income is fact so dealt with by any person as to be calculated at some point of time and, whether in the form of income or not, to ensure for the benefit of the first mentioned person in sub-section (1) or
- (ii) The receipt or accrual of the income operates to increase the value to such first mentioned person of any assets held by him or for his benefit, or
- (iii) such first mentioned person receives or is entitled to receive at any time any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and assets which represent that income, or
- (iv) such first mentioned person has power by means of the exercise of any power of appointment or power of revocation or otherwise to obtain for himself, whether with or without the consent of any other person, the beneficial enjoyment of the income, or
- (v) Such first mentioned person is able in any manner whatsoever and whether directly or indirectly to control the application of the income

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- (d) In determining whether a person has power to enjoy income, regard shall be had to the substantial result and effect of the transfer and any associated operations, and all benefits which any at any time accrue to such person as a result of the transfer and any associated operations shall be taken into account irrespective of the nature or form of the benefits.

Section 93 (4) defines the terms assets, associated operation, benefit and capital sum as follows:-

- (a) "Assets" includes property or right of any kind and "transfer" in relation to rights includes the creation of those rights;
- (b) "Associated operation" in relation to any transfer, means an operation of any kind effected by any person in relation to -
- (i) Any of the assets transferred, or
  - (ii) Any assets representing, whether directly or indirectly, any of the assets transferred, or
  - (iii) The income arising from any such assets, or
  - (iv) Any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets;
- (c) "Benefit" includes a payment of any kind;
- (d) "Capital sum" means -
- (i) Any sum paid or payable by way of a loan or repayment of a loan; and

#### **Anti-Tax Haven Measures**

It would now be useful to mention how to check the abuse of such tax haven countries. In this context, anti-tax haven measures taken by Japan are briefly explained. The Japanese Diet, on the basis of the findings of the report on revision of taxation system for fiscal year 1978 submitted by the Tax Council to the Prime Minister introduced two new sub-sections in the Special Taxation Measures Law dealing with cases of individuals and corporations in Japan, which make use of tax haven countries to reduce their tax liability in Japan.

The new legislation defines "Tax Haven Countries" as "Countries and areas in which the tax burden on all income or on particular types of income of corporations is significantly lower than that on income of corporations in Japan, designated as such by a cabinet order classifying them as countries and areas with low rates of taxation on all forms of income or on particular types of income".

The tax-haven countries have been classified into three categories: (1) countries with low rates of taxation on all incomes (2) countries with low rates of taxation on income from foreign sources (3) countries with low rates of taxation on income from specific businesses.

The Anti-Tax haven measures consist of computing taxable income of a domestic corporation, attributing the portion of the undistributed income of its foreign subsidiary corresponding to direct or indirect ownership of stock of the subsidiary such income is included in the taxable income of the domestic corporation and the corporation tax is levied. This basis is followed when the domestic corporation owns directly or indirectly 10% or more of the total stock of the foreign subsidiary, and more than 50% of the total stock of the subsidiary is directly or indirectly owned by domestic

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corporations and residents in Japan. The condition regarding stock ownership is determined on the basis of the situation existing at the end of the business year of the foreign corporation.

However, the anti-tax haven measures are not applicable if the foreign subsidiary satisfies all the following conditions:

- (1) The foreign subsidiary has a fixed facility such as an office, shop or factory which is deemed necessary to conduct its business in the country where its main office exists.
- (2) The foreign subsidiary conducts the management and control of its business in the country where its main office exists.
- (3) In case the main business of the foreign subsidiary is wholesale, banking, trust, securities business, insurance shipping or air transport, the foreign subsidiary conducts its business mainly with persons other than related persons.
- (4) The foreign subsidiary is not a corporation whose main business is to hold stocks, to offer patents or copyrights etc. or to lease vessels or aircraft.
- (5) The amount of dividends received by the foreign subsidiary from other foreign corporations which come under these taxation measures does not exceed 5% of its total revenue.

In addition to the above provisions, the new measures also contain provisions to eliminate double taxation with respect to foreign corporation tax imposed on undistributed income of the foreign subsidiary attributed to the domestic corporation and payment of dividends from already taxed income of the foreign subsidiary.

It is suggested that measures similar to the anti-tax haven measures taken by Japan be taken in our country also by amending the Income-Tax Act.

#### **OTHER ANTI-TAX AVOIDANCE/EVASION MEASURES**

It may be remained that in the context of tax avoidance and tax evasion an important solution to such a problem s to enlarge the field of international cooperation in dealing with tax dodgers by entering into comprehensive tax treaties with other countries, particularly those with whom we have economic relations and trade on a substantial scale. The United States of America has entered into comprehensive tax treaties with several countries, including Canada and Switzerland.

To be assistance in tackling tax evasion, tax treaties should have a provision for automatic exchange of routine information relating to payment of interest, commission, royalty etc. to residents of the other contracting state. The agreement should also provide for exchange of commercial intelligence which is vital for dealing with international tax evasion. This is necessary because it will otherwise be difficult to establish fraud successfully, particularly when it relates to under invoicing or over invoicing. The agreement should also facilitate exchange of general information relating to tax laws and fiscal policies. The most important role which such agreements can play is, however, in the field of investigation of specific cases of tax fraud and recovery of taxes due from those who have assets in other country, by providing for exchange of information relating to such cases and by making administrative machinery for investigation and recovery of the one country available to the other. In this context, it is generally observed that a developed country does not agree to such clauses. However, the good offices of the United Nations must be used by the less developed countries to

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persuade the developed countries to enter such a clause in the agreements. It must be pointed out that India does not have any comprehensive double taxation avoidance agreement with the United States, its main trading partner. Even with the United Kingdom, another important trading country, it was only last year that a comprehensive double taxation avoidance agreement was entered into.

It is, therefore, suggested that the double taxation avoidance agreements should provide for exchange of routine information and market intelligence as also specific information in individual cases to facilitate investigation of tax evasion and recovery of taxes. The agreements should also enable the Courts in both the contracting countries to entertain and to seek for information and evidence from the tax authorities of the other country. The agreements should further provide for mutual assistance in investigation of tax frauds and recovery of taxes by making the administrative machinery of each available to the other.

It is also submitted that knowledge of income-tax is not sufficient for the tax administrators to tackle the problem of tax evasion since it is linked with transactions such as over invoicing or under invoicing in import or export business, operation through secret foreign bank accounts directing funds outsider India and operating from tax have countries. It is, therefore, recommended that the tax administrators should be trained in international business activities and there should be regular monitoring of economic data and market intelligence.

There is no denial of the facts: evasion of tax is rampant, proliferation of black money is vast, parallel economy is creating havoc; there lay ample provisions of tax laws to check on tax evasion. When I analyses the reasons. I believe (a) there is constant erosion of human values; (b) there is no education of tax laws; (c) no social stigma is attached, on the contrary tax evaders having money power and vast resources get respect in the society.

In CIT vs. A Raman & Co. (1968)67 ITR 11 (SC) : TC 51R 423, the supreme court observed: "Avoidance of tax liability by so attending commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may locate to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented" the supreme court again observed in CIT vs. B.M. Kharwar (1969)72 ITR 603 (SC) : TC 29R 210: "The taxing authority is entitled and is indeed bound to determine the true legal relation resulting form a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of the relationship. But the legal effect of transaction cannot be displaced by probing into the 'substance of the transaction'. However, the observations on tax avoidance stand disapproved by the Supreme court in McDowell & Co. Ltd. vs. CTO (1985) 47 CTR (SC) 126 : (1985) 154 ITR 148 (SC).

Mr. justice Mishra in McDowell's case stated the position thus "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 of 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". The court also quoted with approval the decision of the Gujarat High Court

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in CIT vs. Sakarlal Balabhai (1968)69 ITR 186 (Guj) : TC 40R 731, which decision stands affirmed by the supreme court in CIT vs. Sakarlal Balabhai 1972 CTR (SC) 321 : (1972) 86 ITR 2(SC) : TC 40R 740: "Tax avoidance postulates that the assessee is in receipt of an amount which is really and in truth his his income liable to tax but on which he avoids payment of tax by some artifice or device. Such artifice or device may apparently show the income as accruing to another person, at the same time making it available for use and enjoyment to the assessee as in a case falling within section 44D or mask the true character of the income by disguising it as a capital receipt as in case falling within section 44E or assume diverse others forms... But there must be some artifice or device enabling the assessee to avoid payment of tax on what is really and in truth his income. If the assessee parts with his income producing asset, so that the right to receive income arising from the asset which, therefore, belonged to the assessee is transferred to and vested in some other person, there is no avoidance of tax liability: no part of the income form the asset goes into the hands of the assessee in the shape of income or under any guise... "The apex Court in McDowell's case after referring to a number of decisions. English as well as Indian, arrived at the final conclusion: "In our view, the proper way to construe a taxing statue, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, not whether the transaction is not unreal and not prohibited by the statue, 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".

All the expressions used by their Lordships in deprecating the methodology of tax avoidance through tax planning by resorting to "colorable device", "dubious methods or subterfuge" have special significance in the legal world. In the context of the present discussion, the meaning assigned to "colorable" in Brown's Judicial Dictionary has been defined as the "reverse of bona fide". Black's Law Dictionary explains "colorable to mean "that which is in appearance only, and not in reality, what is in appearance only and not in reality what it purports to be, hence counterfeit, feigned, having the appearance of truth". So also a device. "The context in which the expression device has been used in its ordinary dictionary meaning as per the shorter Oxford Dictionary means "ingenuity, something devised, arrangement, plan, contrivance a plot or a trick. Black's Law Dictionary refers to device as contrivance a scheme, trick. Subterfuge, according to the ordinary meaning as per the Shorter Oxford English Dictionary means that to which one refers for escape or concealment" Subterfuge on historical principles means, an article or device to which a person refers in order to escape the force of an argument, an excuse with which conceals a clue. So also the expression "dubious" refers to a doubtful or of questionable character. That is to say what has been deprecated as tax planning for avoidance of tax are those acts which have doubtful or questionable character as to their bona fide and righteousness. Not all legitimate acts of taxpayer which in the ordinary course of conducting his affairs a person does and are under law he is entitled to do, can be branded as being of questionable character on the anvil of McDowell's case.

On analysing the McDowell's case, I am of the opinion that while planning adopted as a device to avoid tax had been deprecated, the principle cannot be read as laying down the law that a person is to arrange his affairs so as to attract maximum tax liability, and every act which results in tax reduction, exemption of tax or not attracting tax authorized by law is to be treated as device of tax avoidance.

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The decision in McDowell's case came to be considered the supreme court in the case of CWT vs. Arvind Narottam (1988) 72 CTR(SC) 94 : (1988) 173 ITR 479 (SC). Chief Justice Pathak opined that McDowell's case cannot advance the case of the Revenue because the language of the deeds of settlement is plain and admits no ambiguity. Justice S. Mukherjee opined "Where the effect on the construction of the deeds is clear as in this case, the appeal to discourage tax avoidance is not relevant consideration. But since it was made, it has to be noted and rejected",

The Gujarat, High Court in *Banyan & Beny vs. CIT* (1996) 131 CTR (Guj)127: (1996) 222 ITR 831 (Guj) : TC 44R 1257 observed "The real question to be asked while examining is whether the act of an assessee falls in the category of a colorable device, a dubious method or subterfuge of an act of which the judicial process may not accord approval. Carrying on a trade is the fundamental right guaranteed under Article 19 of the Constitution of India. The right to carry on trade includes the right not to carry on any trade. How and in what form business is to be carried on is also part of that freedom".

The Madras High Court in *M.V. Valliappan & Ots. vs. ITO* (1988) 67 CTR (Mad) 289 : (1988) 170 ITR 238 (Mad) : TC 37R 660, held that a legitimate transaction which does not amount to a dubious device is not hit by the new approach adopted by the English Courts and by the Supreme Court in McDowell's case.

Very recently the Supreme Court on October 7, 2003 in *Union of India and Another Vs. Azadi Bachao Andolan* (2003) 263-ITR-706 by a well-reasoned order approved the view expressed in *M.V. Valliappan* case (supra) and *Banyan and Berry* Case (supra) and commented on the observation of Chinnapa Reddy J. in *McDowell & Co's* case (supra) at page 753-763 of the reporting. The fear of the McDowell has been watered down. After detailed analysis it observed : "We are unable to agree with the submission that an act which is otherwise valid in law can be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents."

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