
THE CONUNDRUM OF STATUTORY INTERPRETATIONAL APPROACHES IN RESOLVING ‘TAX AVOIDANCE’ DISPUTES IN INDIA

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ABSTRACT

This paper explores the debate between tax avoidance and tax evasion in India, focusing on how courts interpret taxation statutes. Taxes are essential for funding public services and national development, yet individuals and businesses often seek to reduce their tax burden. When tax liability is reduced by legally using loopholes or gaps in the law, it is considered tax avoidance. In contrast, tax evasion involves illegal acts such as concealment, fraud, or misrepresentation.

A key theme discussed is the principle of strict interpretation of taxing statutes. Courts are required to interpret tax laws based on their plain and literal meaning. Under Article 265 of the Constitution of India, no tax can be imposed without clear authority of law. Therefore, courts cannot expand the scope of taxation beyond what the legislature has expressly stated. In cases of ambiguity in charging provisions, the benefit generally goes to the taxpayer, while ambiguity in exemption provisions favours the revenue.

The paper analyses landmark judgments such as *McDowell & Co. Ltd. v. CTO* (1985) and *Vodafone International Holdings v. Union of India* (2012), highlighting the shift from a moralistic to a formalist judicial approach. It concludes that tax avoidance and tax evasion are legally distinct, and that clear legislative drafting and judicial restraint are vital for maintaining certainty and fairness in India’s tax system.

Keywords: Tax Avoidance, Tax Evasion, Strict Interpretation, Westminster Principle, Fiscal Jurisprudence.

INTRODUCTION

“Taxes are the price we pay for a civilised society.”

- *Oliver Wendell Holmes Jr.*

Paying taxes often presents a dilemma for individual and businesses where on one hand it is considered as burdensome because they reduce the disposable income and profits but on the other hand it is a fundamental responsibility by which funds essential for public services are provided to the government. Taxes are the price we pay for civilised society and nation building. By making individuals and businesses to compulsorily contribute a portion of their earning, taxation ensures that Government has enough resources and funds in order to discharge its primary function of providing essential services for public good in order to facilitate overall development of the society. However, in present state of the world, everyone is driven by a capitalist tendency of profit maximisation which prompts people to find ways to avoid taxes by using loopholes in the taxation statutes. This is what we refer as practice of Tax Avoidance.

A well-drafted taxing statute facilitates maximum revenue generation by providing little scope for the discretion in its implementation. However, no statute can be said to be perfectly drafted and as a result, there exist certain gaps which are exploited legally for reducing tax liabilities. Tax avoidance is a method of reducing tax liabilities by exploiting these legislative gaps and loopholes in the taxing statutes by being on the right side of the law.¹ The practice of tax avoidance has always been in debate that whether it is same as tax evasion or not given the factually similar behaviour of the taxpayer in both cases.² This debate often results in litigation where the tax authorities claiming such practices to be ‘tax evasion’ for being against the spirit of the law, while others argue that claiming such practices are completely legal since no law has been violated.

While dealing with the ambiguities in the taxing statutes, other than general principles of statutory interpretation, court is guided by certain rules of interpretation which are specifically for taxing statutes. One of the fundamental rule of interpretation of taxing statute is that it’s provisions must be construed strictly and if there exist any deficiency, Court cannot make it

¹ A. K. Jain, *Tax Avoidance and Tax Evasion- The Indian Case*, 21 *Modern Asian Studies* 233, 233 (1987).

² *Ibid.*

good and it must interpret it as it stands and in case of an ambiguity it shall be interpreted in the favour of the taxpayer.³

In India, the 'Tax Avoidance' jurisprudence have been studied mainly around two landmark judgements, first is McDowell's case⁴ and second is Vodafone case⁵, where the effect of McDowell case was diluted by Vodafone case. In 1985, the interpretation made in McDowell case, blurred out the thin line of difference between 'tax avoidance' and 'tax evasion' which allowed the taxing authorities to include fair and legal practices of tax avoidance to be named as tax evasion. However, later in 2012, the case of Vodafone ruled against the decision of McDowell case and by applying the rules of interpretation of Taxation Statutes, practice of tax avoidance was considered as legal as long it is within the right side of the law.

Through this research paper, the author has delved into the lesser discussed area of statutory interpretation which is specifically related to interpretation of taxation statutes. Every member of the legal community at least once goes through the basic principles of statutory interpretation which are followed generally for all statutes, however, there are certain special rules for interpreting the taxation statutes which are often neglected or receive less academic attention. Hence, by keeping the issue of 'Tax avoidance v. Tax evasion' at the centre, this paper has in detail discussed the special rules of interpretation of taxation statutes along with relevant general principles of statutory interpretation. Discussing the landmark cases of McDowell and Vodafone along with other relevant case laws, the undertaken research is an attempt to examine the rules of interpretation of taxation statute by analysing interpretational approach used by judges in resolving the 'Tax avoidance' disputes in India.

UNDERSTANDING THE RULES OF STATUTORY INTERPRETATION OF TAXING STATUTES

THE FUNDAMENTAL PRINCIPLE OF STRICT INTERPRETATION

While construing a tax statute, the fundamental rule is to interpret it strictly. Supreme Court in the case of *M/s Hiralal Ratanlal v. STO*⁶, stated that “ *in construing a statutory provision the first and foremost rule of construction is the literary construction. The other rules are called*

³ Ramamurthy. S, *Introduction to Taxation*, 25 (2023).

⁴ *McDowell and Co. Ltd. v. CTO* (1985) 3 SCC 230.

⁵ *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 613.

⁶ AIR 1973 SC 1034.

into aid only when the legislative intent is not clear.” Rule of strict interpretation means words in the provision shall be read with their plain, ordinary and grammatical sense and when such meaning is precise and clear, the intention of the legislature has to be gathered from the plain meaning of the words used in the statute.

This principle is applied with greater emphasis while interpreting taxing statutes and is the fundamental principle in interpreting it. While discussing the principles governing the interpretation of taxation statutes, Supreme Court in the case of *Chief Commissioner of Central Goods and Service Tax v. M/s Safari Retreats Private Ltd.*⁷ stated that while dealing with the taxing provision, strict interpretation should be applied. There is no room for any intendment while interpreting taxing statutes. Court can only gather what is clearly intended in the taxing statute by fairly looking at the plain meaning of the language used.⁸ They cannot assume any intention or the purpose beyond what is stated in the plain language in the taxing statute.

Article 265 of the Constitution of India mandates that the taxes shall not be levied or collected except by authority of law. This means that no tax can be imposed on the assessee when the words of the enacted taxing statutes do not suggest that the parliament intended to put such a burden on the taxpayer. In *A.V. Fernandez v. State of Kerala*⁹, Supreme Court stated that if the case strictly falls within the provisions of the law, subject can be taxed, however if the case is not covered within the four corners of the taxing statutes, no tax can be imposed by inference or by analogy or by trying to probe into the intentions of the legislature.

The mandate under Article 265 of Constitution is one of the significant reason in interpreting the taxing statutes strictly as it restrains courts from extending the operation of taxes which can only be levied by a legislation. Also, strict interpretation ensures uniformity in imposition of taxes and tax obligations, protecting citizens from the ambiguity which may be created by various interpretations of the courts.¹⁰

Hence, it is understood that the rule of strict interpretation is fundamental in interpreting the taxing statutes and if the language of the provision is plain courts must interpret the words of the it in literal and plain meaning with no additions or subtractions of the grounds of legislative

⁷ 2024 (10) TMI 286.

⁸ *Cape Brandy Syndicate v. Inland Revenue Commissioner* (1921) 1 KB 64

⁹ AIR 1957 SC 657.

¹⁰ M. Katju, *Interpretation of Taxing Statutes*, 8 (2nd ed., 1998).

intendment or otherwise.

Principle of strict interpretation being fundamental in interpreting the taxing statutes, there are certain key rules to this principle which should be kept in mind. These rules are as follows:

Tax and equity are strangers: In case of fiscal laws and their interpretation, it is well established that tax and equity are strangers to each other, there is no equity about a tax. Learned Judges of the Supreme Court in the case of *Murarilal Prasad v. B.R. Vad*¹¹, observed that a provision which imposes tax has to be construed strictly regardless of the hardship that such construction may cause either to taxpayer or to the treasury. Hence, if the language of the tax provision is plain and clear then equity is out of place. However, if there are two possible interpretations then in such cases one with equity and fairness should be preferred.¹²

Casus Omissus: It is a corollary to the principle of strict interpretation which says that omissions in a statute are not to be inferred. It is based on the rationale that if there is a defect in the texts of a statute then, it is not for court to correct the same, as it would then be encroaching upon the legislative role of the parliament. The general rule suggests that words can be supplied by the court where there are adequate grounds to justify the inference that legislature intended something which it omitted to express. However, this is not applicable in taxing statutes.¹³ Court cannot imply anything which is not expressed. It would not be open for court to import provisions in the taxing statute to supply the deficiency.

Avoidance of Tax: The strict rule of interpretation of taxing statutes allows the taxpayers to arrange their affairs so as to minimise or avoid the tax liabilities. Strict interpretation restrains court from widening the scope of what has been clearly laid down in unambiguous language by the legislature and since it is a constitutional mandate that tax can be imposed by legislation only, the taxable subject which does not fall within the four corners of the law, is used by the taxpayers to minimise their tax liabilities. However, although a person is allowed to arrange his affairs to avoid tax, the arrangement must be on the right side of the law.¹⁴ In *Vodafone International Holdings BV v. Union of India*¹⁵, Supreme court observed that tax cannot be levied unless explicitly mentioned in the statute, legislature alone has the power to impose tax

¹¹ [1976] 37 STC 77 (SC).

¹² CIT v. Madho Prasad Jatia (1976) 4 SCC 92.

¹³ Supra 14, 11.

¹⁴ Supra 14, 14.

¹⁵ (2012) 6 SCC 613.

and a legitimate business arrangement company cannot be considered as sham even if it led to tax avoidance. Also, in *Chief Commissioner of CGST & Ors. v. M/s. Safari Retreats Private Ltd. & Ors.*, Supreme Court noted that there is nothing unjust in the taxpayer escaping if the letter of law fails to catch him on account of the legislature's failure to express itself clearly.

All these principles reinforce that tax laws must be applied as written, without judicial intervention based on equity or assumptions. It is best explained by the maxim: *absoluta sententia expositore non indiget*, meaning 'a sentence that is plain and absolute does not need an expositor'. The language used by the legislature best declares the legislative intent and must be accepted decisively. This strict interpretation allows tax avoidance to exist legally by preventing courts from imposing taxes where the law does not explicitly require them.

Exceptions to the principle of strict interpretation

1. Machinery provisions, which lays down procedural aspect regarding assessment or reassessment of the taxing provisions, may be construed liberally if the situation demands so. The principle of strict interpretation is not applicable while construing machinery or procedural provisions.¹⁶
2. Where the strict interpretation would defeat the intention of the legislation and produce a wholly unreasonable and unjust result, the courts must in order to achieve the object and intention of the legislation avoid the rules of strict interpretation. Supreme Court in the case of *Shree Sajjan Mills v. CIT, Bhopal*¹⁷, held that while the principle of strict interpretation applies to the fiscal statutes, it does not rule out the application of the principles of reasonable construction to give effect to purpose of intention of any particular provision which is apparent from the scheme of the Act.
3. Where the strict interpretation leads to absurdity, then in such cases one can depart from rule of strict interpretation. Court must make effort to interpret provisions in a way which will provide remedy intended by the legislation and avoid the mischief in order to make the legislation workable and enforceable instead of rendering it futile either wholly or partially.
4. Where strict interpretation poses difficulties, then if two interpretations are possible, the

¹⁶ Kanga, Palkhivala, *The Law and Practice of Income Tax*, 22 (11th ed., 2020)

¹⁷ AIR 112 1986 SC 484.

interpretation which upholds the constitutionality of the statute or advances the object of the statute should be preferred. Purposively interpreting the provision allows to understand the purpose with which a particular provision was inserted by the legislature. In case of ambiguous terms, the court may look into the context in which the provision appears or it may look into the mischief which the act sought to remedy, and the meaning attributable to the ambiguous term has to be interpreted in reference with the context and purpose of the particular provision.

SPECIAL RULES FOR INTERPRETING TAXING STATUTES

Ambiguity should be interpreted in favour of the assessee

In case of taxation statutes, where a provision has two possible interpretations, then the interpretation favourable to the assessee has to be accepted. Court would ordinarily interpret the provision in favour of the taxpayer and against the revenue.¹⁸ The jurisprudential justification for this principle is that in governance of rule of law by a written constitution, there is no implied power of taxation. The power to tax the subjects must be specifically conferred and it should be strictly in accordance with the power endowed by the constitution. A subject is not be taxed unless the words of the statute are unambiguously impose a tax on it, which is why in case of an ambiguity in a provision, the interpretation is made in favour of the taxpayer.

However, the exception to this rule is that ambiguity in case of an tax exempting provision has to be interpreted in the favour of the revenue. Hon'ble Supreme Court in the case of *Commissioner of Customs (Mumbai) v. Dilip Kumar & Co.*¹⁹ laid down that “where two views are possible in respect of an exemption provision in tax statute, the strict rule of interpretation has to be applied and the benefit of the doubt must go to the revenue.” The rationale was that the ultimate beneficiary of exception clause is the revenue and not the taxpayers because the burden of proving the applicability of exemption clause is on the assessee to show that his case squarely falls within the exemption clause and if he fails to do so, the beneficiary will be the revenue and not the assessee.²⁰

¹⁸ Commissioner of Customs (Import), Mumbai v. Dileep Kumar & Company & Ors. (2018) 9 SCC 1.

¹⁹ 69 GST 239 (SC)

²⁰ Ibid, at para 66.

Words used in taxing statute to be construed in its commercial sense

It is a basic canon of interpretation that each statute defines the expressions used in it and those definitions shall not be used to interpret other statute unless in any other cognate statute the expression is not defined.²¹ This is because a specific word or expression occurring in one section of the statute have a particular object, it cannot carry the same meaning in other section of the same Act or even in any other statute which is enacted for different purpose. If the objects of two sections or the statutes are different, the same words and expressions used in those statutes will carry different meanings.²² Hence, word used in one statute shall not be used as a guide to the construction of the same word in another statute, unless both the statutes are cognate in nature.²³

Where a word used in a taxing statute, has not been defined specifically, then in such case the interpretation of the word shall not be done in accordance with the definition of the same in another statute which does not deal with a cognate subject. The meaning of the undefined word should be understood in its commercial sense. Unless defined in the taxing statute itself, the words and expressions in the taxing statute have to be construed in the sense that the person dealing with the same understands, i.e. as per its technical usage in trade and commercial practice.²⁴

UNDERSTANDING THE DEBATE BETWEEN 'TAX AVOIDANCE' AND 'TAX EVASION'

Paying of taxes is considered as a social responsibility of every individual and corporate entity in order to provide funds for essential public services such as healthcare, education and infrastructure development. Loss of revenue to government has always been a significant issue for any country because of its critical impact on everyday lives of the people. This brings us to the issue of 'tax avoidance', a lawful practice of reducing tax liabilities, which is considered as immoral and unethical practice having same effect as that of 'tax evasion' i.e. the loss of public revenue. The debate of tax evasion and tax avoidance has arise due to the increasing tax avoidance practices by the corporate entities which ultimately puts the tax burden on the working class of the population who have little or no scope to avoid taxes. However, whatever

²¹ All Kerala Chartered Accountants' Association vs. Union of India & Others (2002) 258 ITR 679.

²² J.C.I.T. vs. Saheli Leasing and Industries Ltd. (2010) 324 ITR 170.

²³ Jagatram Ahuja vs. C.I.T. (2000) 246 ITR 609.

²⁴ Supra 22, at para 25.

may be the consequences, the moral argument of tax avoidance being at the same footing as tax evasion still struggles to find its justifiability.

Tax avoidance and tax evasion entails similar behaviour of the taxpayer wherein the broad aim is to minimise or to eliminate the tax liability. Practices of tax avoidance and tax evasion both cause significant loss of revenue to the Government. However, being factually similar with respect to end result, they are distinct in legal sense. Tax avoidance refers to the use of legal methods to minimize tax payments by exploiting loopholes in tax laws, often through strategic financial planning, offshore accounts, and corporate restructuring. Tax evasion, on the other hand, is an illegal act involving deliberate misrepresentation, concealment of income, or fraudulent practices to avoid paying taxes.

Lord Nolan in the case of *Commissioner of Inland Revenue v. Auckland Harbour Board*²⁵, has captured the essence of tax avoidance: “The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability.”

Since, the practice of tax avoidance is carried out within the four corners, the authority even if detects the avoidance scheme, they won't be able to charge criminal punishment against the same. However, the position is completely opposite in case of tax evasion wherein the practice is at the face illegal and fraudulent allowing the authorities to penalise the same. In addition to this, in case of tax evasion, transactions are mostly unreported due to avoid any penal actions, whereas in case of tax avoidance the transaction details are not hidden and are usually on record.²⁶

Thus, tax evasion escapes tax but not the threat of social control and carries the risk of criminal penalties; tax avoidance escapes both tax and any risk of criminal penalty. One is law-breaking activity while the other is law-abiding activity. So the difference between the tax evasion and tax avoidance does not lie in their end results but the way these practices are carried out. The motivation or the aim of both the practices is same i.e. to escape tax in order to make private gains at the expense of public loss. By using the law rather than abusing it, the taxpayers can

²⁵ [2001] 3 N.Z.L.R. 289 (P.C)

²⁶ S. Bandyopadhyay, *The problem with tax: Planning, avoidance or evasion?*, Centre for Budget and Governance Accountability 1, 1 (2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2102282, last seen on 06/03/2025.

achieve the same ends as evasion without any risk of criminal penalties which tax evasion entails.

It is the law that draws a line between tax avoidance and tax evasion; however, from economic or moral point of view, there is hardly any difference between the both given the broader aim of these practices is to minimise or eliminate tax liability which is unfavourable to the tax system. Both these practices are the forms of non-compliance which comprises all those activities which are not favourable to the tax system of the country. The government characterizes both tax evasion and tax avoidance as contrary to the spirit of the law and a case which may be legal and yet highly immoral to the intent of the law.²⁷

Surely, if we look at tax evasion and tax avoidance from economic and moral angle, it suggests no difference between these practices as they both have same effect i.e. loss of public revenue to the government which is also against spirit of the law which requires strict compliance of the legislation by paying taxes according to the one's ability to pay. However, mere economic or moralistic ideals doesn't justify to consider the practices of the tax evasion and tax avoidance on same footing.

It is true that the citizens of the country must pay taxes as it is the price we pay for a civilised society. Spirit of the fiscal laws is about making people contribute towards the public revenue by paying taxes, it's not about making them pay the maximum possible tax possible. If the spirit of law means that an individual must refrain from taking any action which will reduce his taxes, then it is in itself against the scheme of the government. One cannot be asked to pay taxes simply because he/she is morally obligated to do so; if the law falls short of enforcing any moral obligation, the government cannot ask him do so otherwise. A citizen refraining from making voluntary contribution to support the government has nothing to do with morals. In case of taxation statutes, law and morality are strangers. A man has a moral and legal right to preserve his earning for the welfare of his family and development of business and has every right to reduce his tax liabilities if the law allows him to do so.²⁸

In the case of *Bullen v. Wisconsin*, Learned Judge Hand of the Circuit court of Appeals said that "*Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic*

²⁷ M. B. Angell, *Tax Evasion and Tax Avoidance*, 38 Columbia Law Review 80, 87 (1938).

²⁸ *Ibid*, at 88.

duty to increase one's taxes."²⁹ What is understood from this ruling is that there is nothing unlawful or even mildly unethical in avoiding some portion of the burden of the taxation. This is best explained in the case of *Satwell v. Commissioner*, wherein the First Circuit said that "Nothing is better settled than that persons are free to arrange their affairs to the best advantage for themselves under the law as it stands. A purpose to minimize or avoid taxation is not an illicit motive."³⁰

Problem is not in the ways in which the taxpayers are avoiding the tax liabilities but the ways in which the legislations are drafted. Taxpayers have the right to arrange their affairs in such manner which reduces their tax burdens and the government cannot refrain them from doing so if it is completely legal. This is the reason why even court fails to cure the defects of the legislation as it is not for the courts to do it. In case of taxation statutes, courts are bound to interpret the laws in strict manner and if the legislation fails to bring the avoidance practices within the four corners of the law, it is not open for the courts to bring them within the law.

Hence, putting tax evasion and tax avoidance on same footing on the basis of morality is not justifiable argument. From economic angle, it is true that both the practices result in the loss of the revenue to the government, however, it cannot be the reason to consider both the practices as same. Where the tax evasion is prima facie illegal due to the fraudulent intent of escaping tax, practice of tax avoidance does not encroach the boundaries of law, the taxpayer reduces his tax liabilities by using the ambiguities and loopholes in the existing laws which makes the practice of tax avoidance completely legal in the sense that the taxpayer cannot be penalised for those acts which the law fails to bring them under its taxation scheme.

JUDICIAL APPROACH IN RESOLVING TAX AVOIDANCE DISPUTES

ISSUE IN TAX AVOIDANCE JURISPRUDENCE

Issue of tax avoidance is not new, time and again the courts have been dealing with the disputes of 'tax avoidance' wherein the tax authorities argue that the practice of avoiding tax is nothing but a colourable device of evading taxes. However, it has also been argued that the avoiding taxes by bending the rules of tax system is not illegal when it is within the letter of the law rather than spirit of the law. Practice of avoiding taxes is carried out by utilising the ambiguities

²⁹ Supra 31, 83.

³⁰ Supra 31, 84.

and loopholes in the taxation statutes and it is the cardinal principle of interpreting taxation statutes that the language of the statute has to be read as it is in strict sense, no matter how harsh the consequences are.

The judicial advertence to the disputes of the 'tax avoidance' in India have been based on the well-established *Duke of Westminster* principle which says that "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".³¹ The rule of strict interpretation along with the Duke of Westminster principle have made the Indian courts to recognise the practice of tax avoidance as legal. However, this popular narrative got changed in 1985 when Justice Chinnappa Reddy in the case of *McDowell and Co. Ltd. v. CTO*, opined that:

"it is high time for the judiciary in India too to part its ways from the principle of Westminster and the alluring logic of tax avoidance, we now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation."

This observation of Justice Chinnappa Reddy, opened the gates for moralist school of thought in Indian jurisprudence of 'tax avoidance' which held the view completely opposite to the formal school of thought where strict interpretation and Westminster principle were dominant. However, later in the case of *Vodafone International Holdings BV v. Union of India*, the Supreme Court went back to the Westminster principle to favour the tax avoidance strategies going against the ruling in McDowell's case.

FORMALIST APPROACH

Formalist approach follows the strict interpretation of the taxation statutes wherein, the courts look at the literal meaning of the words used by the legislature in the statute and refrain from going beyond what has been said, whatever may be the consequences. The inspiration to the formalist approach can be found in two prominent English cases, *Cape Brandy Syndicate* and *Duke of Westminster*.

³¹ *Duke of Westminster v. Commissioners of Inland Revenue* [1936] AC 1 (HL).

Justice Rowlett in *Cape Brandy Syndicate v. Inland Revenue*³², laid down that “in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only fairly look at the language used.” Later, Lord Tomlin in the case of *Duke of Westminster v. Commissioners of Inland Revenue*³³ laid down a principle, now known as Westminster principle, which says that every person is entitled to arrange its affairs in way which reduces his tax liabilities under the Act.

In India, we can find the application of the above stated rules in several cases. One such case was *Commissioner of Income Tax v. A. Raman and Co.*³⁴ where the tax authorities challenged the practice of taxpayer wherein the products of the taxpayer are sold to other business entities which are under the control of the taxpayer in the manner that the income which could have been earned by the assessee was not earned by it directly but through other business entities. To this Supreme court declared that “income which accrues to a trader is taxable in his hands: income which he could have, but has not earned, is not made, is not made taxable as income accrued to him.” Further, in line with the Westminster principle Supreme Court ruled that “effectiveness of the device does not depends upon the morality, but on the operation of Income Tax Act. Legislative injunction in taxing statute may not, except on peril of penalty, be violated, but it may lawfully be circumvented.”

The ruling in the above case was referred in *CIT v. Calcutta Discount Co. Ltd.*³⁵, where the taxpayer company reduced its tax liabilities by transferring shares held by it to the subsidiary company in exchange for latter's shares at a price lesser than the market price. Tax administration sought to tax the difference between the transfer value and market value. Supreme Court herein held that the act of reducing the tax liabilities by forgoing its own profit and enabling its subsidiary to earn the profit is not impermissible in law and hence approved the reduction of tax liability to conclude that the tax administration cannot take into consideration the market value by ignoring the real prices fetched.

Thus, the above two cases were the landmark decisions which settled the well-accepted proposition of the tax avoidance jurisprudence that law that does make obligation on a person

³² [1921] 1 KB 64.

³³ [1936] AC 1 (HL).

³⁴ (1968)67 ITR 11 (SC).

³⁵ (1973) 91 ITR 8 (SC).

to make maximum profit out of his business transaction and it is open for the taxpayer to arrange his affairs in such ways which minimises his tax burden.³⁶ Hence, the formal approach of judiciary in dealing with the issue of tax avoidance can be seen by its insistence on the two cardinal principles of interpretation of taxing statute which are strict rule of interpretation and refusal of the courts to supply *caus omissus* by making good of the inadvertent deficiency of the legislature. The benefit of the ambiguity in a taxing statute goes in the favour of the taxpayer and if the transaction in question does not fall within the letters of the law, court will not put a strained construction to bring it within the law.³⁷

MORALIST APPROACH

The Formalist approach of the Indian courts in dealing with the tax avoidance disputes was dominant until 1985 when the observations of Justice Chinnappa Reddy in McDowell case unsettled the tax-avoidance jurisprudence in India by bringing in the moralistic perspective to the issue of tax avoidance. The 5 judge bench in this case unanimously held that tax planning may be legitimate but use colourable devices cannot be part of tax planning and same should not be encouraged as it is the obligation of every citizen to pay taxes honestly without resorting to subterfuge. However, it was the opinion of the Justice Chinnappa Reddy which played primary role in positioning the moralistic perspective in tax avoidance jurisprudence.

Justice Chinnappa Reddy recommended to depart from the Westminster principle as in his view 'evil consequences' of tax avoidance are manifold, namely: (a) substantial loss of public revenue; (b) increase in black money; (c) lack of ethics in transferring the tax burden on the shoulders of the working class from the 'artful dodgers' by permitting tax avoidance. He diminished the formalistic idea by observing that it is essential to recognise that there exist behind tax laws a moral sanction as much as it exist in welfare legislations and called for the courts to take stock of the new colourable devices to avoid taxes and consider whether the situations created by such devices could be brought within the existing legislation with the aid of new techniques of interpretation.³⁸

³⁶ K. Gautam, V. Jaishal, *Tax Avoidance Jurisprudence in India: Questioning the Traditional Narrative*, 5 (1) National Law School Business Law Review (2019), available at: <https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1067&context=nlsblr>, last seen at 08/03/2025.

³⁷ T. Jain, *Deciphering the Judicial Approach to Tax Avoidance: The Ultimate Test for GAAR in 574, 576 in General Anti-Avoidance Rules: The Final Frontier?* (M. Butani, T. Jain, 1st ed., 2021).

³⁸ *Supra* 43, 582.

The McDowell ruling paved way for the courts to consider moralistic perspective in dealing with the tax avoidance disputes. Thus, the recommendation to disregard the formal approach and recharacterize the colourable business transactions based on their economic sense has been addressed in some of the case. Courts were now inclined to lift the corporate veil if any business entity is being used for tax evasion or to circumvent tax obligation or to perpetuate a fraud³⁹ in order to pay regard to the economic realities behind the legal façade.⁴⁰

Before McDowell Case, the similar approach was taken by the court in *Juggi Lal Kamalpat v. CIT*⁴¹, wherein the Supreme Court agreed with the contentions of the tax administration that the transaction of termination of managing agency was a colourable transaction as the partners of the firm continued to run and enjoy the benefits of agency as shareholders and directors of the newly formed company. Herein, Supreme Court rejected the contention of the taxpayer that mere intention on the party of the assessee to evade income tax will not nullify a lawful transaction and held that a transaction stage-managed merely with a view to evade income tax cannot sustain.

Another case wherein Supreme Court applied moralistic approach in tax avoidance dispute was in *Commissioner of Customs v. Phoenix International Ltd.*⁴². herein, due to a policy restriction, shoes could not be imported in India in a semi knocked condition meaning where the parts are essentially complete to make the identified product. In this case the taxpayer imported various parts of the shoes from two entities and tax administration claimed to disregard the other entity on the ground of it being a dummy unit of the taxpayer and therefore the entire imports were to be assessed as the imports of the taxpayer. Herein, Supreme Court favouring the tax administration, opined that “when there is an allegation of subterfuge, the court has to examine the circumstances surrounding the import to ascertain whether the importer had entered into fictitious arrangement to evade customs duty. The intention behind the act of importation has to be probed by looking at the entire composite picture.” Supreme Court disregarded various statutory standards related to the classification of imported goods in order to declare circular trading transactions impermissible based on the idea that they were carried out with sole intention of evading tax.

³⁹ Union of India v. Playworld Electronics Pvt. Ltd. (1989) 3 SCC 181.

⁴⁰ Supra 43, 579.

⁴¹ (1969) 73 ITR 702 (SC).

⁴² (2007) 10 SCC 114.

JUDICIAL ATTEMPTS IN DILUTING THE EFFECTS OF MCDOWELL CASE

The sui generis opinion of Justice Chinnappa Reddy in the McDowell Case brought ripples in the settled position of tax avoidance jurisprudence. This raised the question that whether the popular narrative of the courts in recognising tax avoidance practices as legitimate still holds relevance or not?

The McDowell ruling comprised of 5 judges bench, however two prominent 3 judges bench rulings of the Supreme Court have made an attempt to dilute the effects of McDowell case wherein they ruled the tax avoidance practices carried out by artificial devices as legitimate tax planning. These two cases were the Azadi Bachao Andolan case and the Vodafone Tax case.

Azadi Bachao Andolan Case

The *Union of India v. Azadi Bachao Andolan*⁴³ case involved the Foreign Institutional Investors (FIIs) using Mauritius based shell companies to avoid paying capital gains tax in India. India and Mauritius signed a Double Taxation Avoidance Agreement (DTAA) in 1983 which provided that the companies will only be taxed in their country of residence. Many FIIs, though operating exclusively in India, registered shell companies in Mauritius under the Mauritius Offshore Business Activities Act (MOBA). These “Post Box Companies” were not conducting any actual business in Mauritius but used their registration to claim tax exemptions under the treaty.

Thereafter in 2000 the tax administration conducted inquiry against such companies which revealed that their actual operations were in US and Europe and not Mauritius and hence capital gains tax was imposed on them. Thereafter the Central Board of Direct Taxes issued a circular stating that once a company had obtained the tax residence from Mauritius, it would not be taxed in India.

Matter went to the Delhi High Court challenging the circular for being violative of Income Tax Act and encouraging tax evasion cause of thousands of crores of tax revenue. The Court ruled the circular as unconstitutional for being violative of Income Tax Act and held that DTAA treaty can only be for avoiding double taxation and not for tax avoidance. However, 3 Judges Bench of the Supreme Court in defiance with the McDowell case overturned the Delhi High

⁴³ (2003) 263 ITR 1 (SC).

Court ruling stating that tax planning through treaty shopping is legitimate which could be promoted by the government for attracting foreign investment contributing towards the economic growth of the country.

Vodafone Tax Case

The Vodafone International Holdings BV v. Union of India⁴⁴ case involved the issue of tax avoidance through offshore transactions. The Hutchison Telecommunications International (HTIL) sold its stake in Hutch Essar Limited (HEL) (Indian telecom company) to Vodafone International Holdings BV, which was a Netherland based subsidiary of Vodafone, for \$11.08 billion. The transaction was structured in such a way that the Vodafone technically bought the Cayman islands based company CGP Investments Ltd. which indirectly owned 67% of HEL. Thus, as a result the Vodafone indirectly acquired the Indian asset.

Tax administration claimed that real asset that is being transferred is the HEL which is an Indian based company and therefore capital gains arose from the sale of HEL are taxable under section 9(1)(i) of the Income Tax Act. However, Vodafone argued that the transaction was between two foreign based entities and followed the international tax planning practices without violating any Indian tax laws.

Issue came before Bombay High Court, which ruled in lines with the McDowell case that the transaction was structured to avoid tax liability in India, and the deal was not just a transfer of shares in CGP Investments Ltd. but a transfer of business control and assets of Hutch Essar Ltd. in India. Vodafone should have deducted tax at source before making the payment to Hutchison, as required under Indian law. However, Supreme Court overturned this decision stating that transaction involved acquisition of CGP investments and not of HEL directly. The Court emphasized that tax planning is a legitimate business practice and that Vodafone's deal was not a sham but a legally structured transaction. Justice Radhakrishnan in this case opined that overseas investments in Joint Ventures and wholly owned subsidiaries are important avenues for foreign direct investments, which is an indispensable factor for growing economy like India.

⁴⁴ (2012) 6 SCC 613.

CURRENT LEGAL POSITION ON 'TAX AVOIDANCE' JURISPRUDENCE

The ruling of the Vodafone received appraisal from the High Courts where the tax administration argued to extrapolate a hidden colourable device to allege abuse of tax avoidance. In some of these cases High Courts accepted the arguments of tax administration whereas in some these have been rejected presenting to us a conundrum between formal and moralistic approaches towards tax avoidance disputes.

In *Vodafone Essar case*⁴⁵ of Gujrat High Court, where the tax administration sought to declare a scheme of amalgamation as a colourable device. However, High court followed the formal approach to held that if in its commercial wisdom, a company has decided certain arrangement which benefits the company in tax savings, that itself cannot be a ground to conclude that the sole object of scheme is to defraud the tax authorities. Supreme Court approved the decision of the High Court in this case.⁴⁶

However, in *Shiv Raj case*⁴⁷ of Delhi High Court, tax administration claimed that the sale consideration received on account of non-compete obligations is a 'smokescreen' to avoid tax liability. Herein, High Court agreed with the tax administration to conclude that the non-compete fee being 10 times more than the consideration for sale does not appear to be realistic payment made for non-compete obligation. Even where the law was settled that non-compete fee is not to be taxed, High Court chose not to abide by it when it opined that the claim for legally permitted tax mitigation measure was based on a colourable transaction. However, later on the Supreme Court reversed the ruling on the merit that the assessment of the non-compete fee has to be appreciated from commercial expediency point of view of the tax payer and not the tax administration. It further held that tax department has no business to second guess the commercial expediency of what parties decide for each other.⁴⁸

What can be understood from the Shiv Raj's case and Vodafone Esaar case, the conundrum between the formal and moral school still exist in the high courts too because the tax authorities have been justifying their arguments on the opinion of the Justice Chinnappa Reddy in McDowell case. However, the subsequent decisions of the Supreme Court in the above two cases and also in Azadi Bachao Adolan and Vodafone case seems to have diluted the effect

⁴⁵ Vodafone Essar Gujrat Ltd. v. Department of Income Tax 2012 SCC OnLine 4141 (Guj).

⁴⁶ Department of Income Tax v. Vodafone Essar Gujrat Ltd. (2015) 373 ITR 525 (SC).

⁴⁷ Commissioner of Income Tax v. Shiv Raj Gupta (2015) 372 ITR 337 (Del).

⁴⁸ Shiv Raj Gupta v. Commissioner of Income Tax AIR 2020 SC 3556.

moralistic approach taken in McDowell case. The Supreme Court has been consistently placing its reliance on the formal approach by not imposing its own wisdom on the commercial wisdom of the companies in deciding the legality of any scheme of arrangement. Supreme Court has in various cases reiterated that it is not for the court and tax administration to interfere with the commercial wisdom of the companies, and if through such arrangement the taxpayer mitigates its tax liability it is completely within its right to do so given that it is done within the four corners of the law.

Subsequent to the decision in *Azadi Bachao Andolan*, the argument has been raised by the Revenue in several cases that the anti-avoidance principles in McDowell's case must continue to prevail as McDowell was decided by a Bench of five judges while *Azadi* was decided by a Bench of two judges. This argument is misconceived as it fails to recognize that when a decision of a larger bench of the Supreme Court is interpreted by a smaller bench of the Supreme Court, what would bind all lower authorities is that interpretation which the smaller Bench has placed on the larger Bench's decision.⁴⁹ Hence, from the above discussed cases it is fair to say that the formal approach of strictly interpreting the taxing statutes along with the Westminster principle which allows the taxpayer to arrange its affairs in a way which reduces the tax burden, is the current acceptable position of tax avoidance jurisprudence.

CONCLUSION

Tax avoidance disputes in India reveal the complex interplay between strict statutory interpretation and purposive judicial reasoning. This research has explored how courts have approached the issue through landmark cases like *McDowell & Co. Ltd. v. CTO* (1985) and *Vodafone International Holdings v. Union of India* (2012). While *McDowell* introduced moralistic considerations, blurring the distinction between tax avoidance and evasion, the *Vodafone* case reaffirmed that tax avoidance is legal as long as it adheres to the letter of the law.

Courts generally follow strict interpretation for taxing statutes, ensuring taxpayers are not burdened beyond what is explicitly stated in the law. However, the evolution from a moralistic approach in *McDowell* to a formalist stance in *Vodafone* highlights the judiciary's shift toward prioritizing legal certainty and respecting legislative intent. Loopholes in fiscal statutes, such

⁴⁹ Kanga, Palkhivala, *Law and Practice of Income Tax*, 22 (11th ed.,2020).

as exemptions for agricultural income and narrow definitions of taxable income, enable tax avoidance strategies, emphasizing the need for clearer legislative drafting.

Imposing fiscal burden on the taxpayers, can only be done through a legislation as provided under Article 265, and it is not for the courts to cure the inadvertent defect of the drafters of the tax legislations. In my opinion, the Courts should focus on strict statutory interpretation unless explicitly empowered by law to adopt broader reasoning, ensuring that there is predictability and consistency in tax-related rulings. In conclusion, addressing tax avoidance disputes requires a balanced approach that combines clear legislative drafting with judicial restraint. As India progresses toward its economic goal of becoming a US\$ 7 Trillion economy, ensuring a robust taxation framework will be essential for equitable revenue generation and sustainable development of the country as a whole.

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