

Tax Planning and Ethics in Taxation

Some Key Points

Difference between tax evasion and tax avoidance

The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

"The distinction between 'evasion' and 'avoidance', therefore, is largely dependent on the difference in methods of escape resorted to. Some are instances of merely availing, strictly in accordance with law, the tax exemptions or tax privileges offered by the government. Others are maneuvers involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. The first represents what is truly tax planning, the latter tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact circumvent it with a view to eliminate or reduce tax burden. It is these methods which constitute "tax avoidance".

Substance versus form

Where form prevailed: A firm transferred its business assets to a company formed for its purposes. The same business was carried by the company consisting of the erstwhile partners as its shareholders. The Income-tax Officer sought to withdraw the depreciation allowed (the difference between sale price and written-down value) of machinery. Tribunal and High Court held that there was change only in the form of ownership as persons behind both firm and company were the same. Supreme Court held that legal form should prevail and restored the order of Income-tax Officer. This is a case where the form came to the assistance of revenue *CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC)*.

Where substance prevailed: (1) The assessee received compensation ostensibly paid for premature termination of managing agency and claimed that the receipt was not liable to tax as a capital receipt. The Supreme Court upheld the action of authorities in ignoring the legal façade which merely disguised the real intention between the parties to cloak payment of income nature as a capital one – *Juggilal Kamlatpat v. CIT (1969) 73 ITR 712 (SC)*.

(2) Certain shares were held in the name of others, but the deceased was the real owner of the shares as was found with reference to evidence. The High Court had held that the shares were not includible in the estate of the deceased as they were not in his name.

The Supreme Court pointed out that, in substance, the deceased was the owner though only beneficially and upheld the inclusion for estate duty purposes – *CED v. Alope Mitra (1981) 126 ITR 599 to 611 (SC)*.

Question 1

Mr. Gavaskar sought voluntary retirement from a Government of India Undertaking and received compensation of ₹ 40 Lacs on 31st January, 2012. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of ₹ 15 Lacs, which would carry interest at 8% p.a. Gavaskar's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of ₹ 3 Lacs. Mr. Gavaskar would like to draw a monthly remuneration of ₹ 40,000 and also interest @10% p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business.

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required.

Answer

The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:

1. In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b). Remuneration and interest however should be authorised by the instrument of partnership and paid in accordance with such instrument. Interest to partners can be allowed up to 12% on simple interest basis, while the limit for allowability for partners' remuneration is based on book profit under section 40(b). As per section 40(b)(v) the partners' remuneration shall be allowed to the extent of aggregate of -
 - (a) On the first ₹ 3,00,000 of book profits or in case of loss – ₹ 1,50,000 or at the rate of 90% of book profits, whichever is more
 - (b) on the balance of book profits – at the rate of 60%
2. Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).
3. If a proprietary concern is formed, the salary of Mrs. Gavaskar shall be allowed as deduction under section 37(1).
4. The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of ₹ 3 Lacs is justified in view of her long

experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.

5. An issue arises as to whether remuneration of Mrs. Gavaskar would be includible in the total income of Mr. Gavaskar. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. **However, the clubbing provision does not apply if the spouse possesses technical or professional qualification and the income is solely attributable to the application of his or her technical or professional knowledge and experience.** Further, technical or professional qualification would not necessarily mean the qualifications obtained by degree or diploma of any recognized body [*Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)*] The experience of Mrs. Gavaskar as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.
6. If Mrs. Gavaskar joins the proprietary concern of her husband as employee, remuneration of ₹ 3 Lacs shall be taxed in her hands under the head "salary".
7. If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).
8. The tax rate applicable to an individual depends on the level of his/her income, whereas for partnership firms it is flat rate at 30%. For individuals, the rate of tax is at 10% on income exceeding ₹ 1,80,000 but not exceeding ₹ 5 Lacs and @ 20% for income exceeding ₹ 5 Lacs but not exceeding ₹ 8 Lacs and @ 30% in respect of income exceeding ₹ 8 Lacs for the assessment year 2011-12. Education Cess @ 2% and Secondary and Higher education Cess @ 1% is attracted in both the cases.

Note : Considering the comparatives given above, Mr. Gavaskar is advised to commence a proprietary concern and pay salary to Mrs. Gavaskar. In the event of the business expanding and necessitating inclusion of Mrs. Gavaskar, it can always be resorted to with zero tax consequence by converting into a partnership firm or limited liability partnership, as the case may be, to avail all the advantages.

Question 2

Explain the doctrine of form and substance in the context of tax planning.

Answer

The following are certain principles enunciated by the Courts on the question as to whether it is the form or substance of a transaction, which will prevail in income-tax matters:

- (i) **Form of transaction is to be considered in case of genuine transactions-** It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability whereas, if it is entered into in another form which is equally lawful, it may not. Therefore, in considering whether a transaction attracts tax or not, the form of the

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transaction put through is to be considered and not the substance. **However, this rule applies only to genuine transactions.** [*Motor and General Stores (P) Ltd. v. CIT (1967) 66 ITR 701(AP)*]

- (ii) **True legal relation is the crucial element for taxability** -It is open for the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction. The taxing authority is entitled as well as bound to determine the true legal relation resulting from a transaction. The true legal relation arising from a transaction alone determines the taxability of a receipt arising from the transaction [*CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC)*]
- (iii) **Substance (i.e. actual nature of expense) is relevant and not the form –**
 - (a) In the case of an expenditure, the mere fact that the payment is made under an agreement does not preclude the department from enquiring into the actual nature of the payment [*Swadeshi Cotton Mills Co. Ltd. v. CIT (1967) 63 ITR 57(SC)*].
 - (b) In order to determine whether a particular item of expenditure is of revenue or capital nature, the substance and not merely the form should be looked into. [*Assam Bengal Cement Co. Ltd. v. CIT (1955) 27 ITR 37 (SC)*].

Question 3

Distinguish between Tax planning and Tax Evasion

Answer

Tax planning is carried out within the framework of law by availing the deductions and exemptions permitted by law and thereby minimizing tax liability. Tax planning is an arrangement by which full advantage is taken of the concessions and benefits conferred by the statute, without violation of legal provisions. Tax evasion on the other hand is an attempt to reduce tax liability by dubious or artificial methods or downright fraud. It is illegal and denies the State its legitimate share of tax.

Question 4

Specify with reason whether the following acts can be considered as (i) tax management; or (ii) tax planning; or (iii) tax evasion:

- (i) *P deposits ₹ 50,000 in PPF account so as to reduce his total income from ₹ 3,40,000 to ₹ 2,90,000.*
- (ii) *PQR Industries Ltd. installed an air conditioner costing ₹ 75,000 at the residence of a director as per terms of his appointment; but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation.*
- (iii) *SQL Ltd. maintains register of tax deduction at source effected by it to enable timely compliance.*
- (iv) *R. Ltd. issues a credit note for ₹ 40,000 for brokerage payable to Suresh, who is son of*

R, managing director of the company. The purpose is to increase his income from ₹ 1,40,000 to ₹ 1,80,000 and reduce its income correspondingly.

Answer

- (i) It is a case of tax planning, since depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.
- (ii) It is a case of tax evasion, as the air conditioner fitted at residential place is furniture, depreciable@10%, whereas the rate of depreciation applicable for plant and machinery is higher. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit.
- (iii) It is tax management because maintaining register of payments subject to TDS helps in complying with the obligations under the Income-tax Act, 1961.
- (iv) Net effect of the transaction is reduction of tax liability of the company by improper means. The company is liable to tax at a flat rate of 30% whereas Suresh would not be liable to pay tax since his income does not exceed the basic exemption limit of ₹ 1,80,000. The issue of credit note to reduce the liability of company amounts to tax evasion.

Self-examination Questions

- 1. Explain briefly the concept of tax planning.
- 2. Distinguish between diversion of income and application of income, giving examples.
- 3. Explain the distinction between tax planning and tax avoidance.
- 4. Discuss the methods of tax planning.
- 5. Explain the tax effect of retrospective legislation with the aid of a case law.
- 6. Write short notes on the following in the context of tax planning.-
 - (a) Doctrine of Precedence
 - (b) Doctrine of form and substance
- 7. Discuss the tax planning considerations in respect of salary income.
- 8. What are the tax planning considerations in relation to business?
- 9. What are the tax planning considerations governing the following decisions -
 - (i) Make or buy
 - (ii) Own or lease
 - (iii) Retain or replace.
- 10. Discuss briefly the concept of ethics in taxation.

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11. XYZ Ltd. took over the running business of a sole-proprietor by a sale deed. As per the sale deed, XYZ Ltd. undertook to pay overriding charges of ₹ 15,000 p.a. to the wife of the sole-proprietor in addition to the sale consideration. The sale deed also specifically mentioned that the amount was charged on the net profits of XYZ Ltd., who had accepted that obligation as a condition of purchase of the going concern. Is the payment of overriding charges by XYZ Ltd. to the wife of the sole-proprietor in the nature of diversion of income or application of income? Discuss.

Answer

11. This issue came up for consideration before the Allahabad High Court in *Jit & Pal X-Rays (P.) Ltd. v. CIT (2004) 134 Taxman 62 (All)*. The Allahabad High Court observed that the overriding charge which had been created in favour of the wife of the sole-proprietor was an integral part of the sale deed by which the going concern was transferred to the assessee. The obligation, therefore, was attached to the very source of income i.e. the going concern transferred to the assessee by the sale deed. The sale deed also specifically mentioned that the amount in question was charged on the net profits of the assessee-company and the assessee-company had accepted that obligation as a condition of purchase of the going concern. Hence, it is clearly a case of diversion of income by an overriding charge and not a mere application of income.