CHAPTER 6
MCDOWELL: THE DECISION AND THE RATIO

SYNOPSIS

In the end the words were said: 'I beseech you, in the bowels of Christ, think it possible you may be mistaken.'

—Quoted in J. Brownski, *The Ascent of Man*

In *Azadi Bachao* a Division Bench of the Supreme Court examined at length the Constitution Bench decision in *McDowell and Co. Ltd v. CTO*[1]. The first paragraph of the section dealing with *McDowell* runs as under:

> "The respondents strenuously criticized the act of incorporation by FIIs under the Mauritian Act as a 'sham' and 'a device' actuated by improper motives. They contend that this Court should interdict such arrangements and as if by waving a magic wand, bring about a situation where the incorporation becomes *non est.* For this they heavily rely on the judgment of the Constitution Bench of this Court in *McDowell and Company Ltd. v. Commercial Tax Officer.* Placing strong reliance on McDowell it is argued that McDowell has changed the concept of fiscal jurisprudence in this country and any tax planning that is intended to and results in avoidance of tax must be struck down by the Court. Considering the seminal nature of the contention, it is necessary to consider in some detail as to why McDowell, what it says and what it does not say."

Before this author examines the actual decision and the *ratio* of *McDowell*, it is worthwhile to dispel certain confusions in the judicial reasoning in the above stated assortment of points.

There was no attempt to impeach the incorporation of companies by the residents of the third States in Mauritius on the ground of their **motive** for taking undue advantage of the tax treaty (hereinafter referred as the Indo-Mauritius

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[1]. AIR 1986 SC 649.

Double Taxation Avoidance Convention, (DTAC, for short) between India and Mauritius. The Petitioner's case was that on the proper interpretation of the terms of the bilateral Indo-Mauritius DTAC the persons belonging to third States had no credentials to avail of benefits under the DTAC. In short, such persons did not, in reality, come within the Personal Scope of a DTAC. It is taken as a cardinal principle in the administration of justice that masqueraders are never allowed to cause wrongful gains to themselves and wrongful loss to others. The Petitioner's case was neither concerned with incorporation nor with the *situs* of incorporation; his case was with reference *to the functional approach to the issue of incorporation from the observation post of the income-tax law*. The irrelevance of 'incorporation' as the decisive fact for this purpose is clear from numerous cases from several jurisdictions. One such case is *Furniss v. Dawson*[2] decided by the House of Lords to which reference is made in the Constitution Bench in *McDowell & Co. v. CTO*[3]. In *Furniss v. Dawson*, the Dawson wanted to sell their shares in the family business to a company called Wood Bastow Holdings Ltd. But they wanted to postpone the payment of capital gains tax. So they formed an Isle of Man company ("Greenjacket") and exchanged their shares in the company owning the business for an allotment of shares in Greenjacket. By a preplanned transaction, Greenjacket sold the shares to Wood Bastow for cash. But the Revenue claimed that there had been no "real" disposal to Greenjacket. It was merely a preplanned stage in a disposal from the Dawsons to Wood Bastow and fell outside the exception for a reorganization of share capital. Greenjacket was merely an artificially introduced intermediate party that was never intended to own the shares for more than an instant. Commercially, therefore, the transaction was a transfer by the Dawsons to Wood Bastow in exchange for a payment to Greenjacket. In answering the statutory question: "To whom was the disposal made?" the fact that the shares were routed through Greenjacket was irrelevant. The Isle of Man company ("Greenjacket") continued its existence as an incorporated company but for tax purposes its operative realities were explored.

What matters is the legal effect of facts in the light of the statutory provisions. This is what Lord Hoffmann said in *Norglen Ltd. v. Reeds Rains Prudential Ltd.* [1999] 2 AC 1, 13-14:

> "If the question is whether a given transaction is such as to attract a statutory benefit, such as a grant or assistance like legal aid, or a statutory burden, such as income tax, I do not think that it promotes clarity of thought to use terms like stratagem or device. The question is simply whether upon its true construction, the statute applies to the transaction. Tax avoidance schemes are perhaps the best example. They either work (*Inland Revenue Commissioners v. Duke of Westminster* [1936] AC 1) or they do not (*Furniss v. Dawson* [1984] AC 474.) If they do not work, the reason, as my noble and learned friend, Lord Steyn, pointed out in *Inland Revenue Commissioners v. McGuckian* [1997] 1 WLR 991, 1000, is simply that upon the true construction of the statute, the transaction which was designed to avoid the

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2. [1984] AC 474.
3. AIR 1986 SC 649.

> charge to tax actually comes within it. It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loop holes."

It is apt to refer to the judgment of the Delhi High Court in *Shiva Kant Jha & Anr. v. Union of India & Anr.*[4]:

> "Be it recorded that counsel for the parties have argued before us at great length and raised before us a large number of questions which have been noticed hereinbefore to put keeping in view the fact that only an interpretation of the statute *vis-à-vis* the impugned circular."

For the adoption of this approach in a given case, a court needs three kinds of knowledge[5]:

(a) Knowing the facts;

(b) Knowing the law applicable to the facts; and

(c) knowing the just way of applying law to them.

The whole case of the Petitioner was that, on proper construction of the law, the impugned Circular was bad, and the Indo-Mauritius DTAC was abused. Explaining the *ultra vires rule* Hood Phillips says how the examination of *vires* can be effectively done through the technique of interpretation. He observes: [6]

> "As regards the innumerable statutory powers, the question is one of interpretation of the statute concerned. The acts of a competent authority must fall within the four corners of the powers given by the legislature.[7] The court must examine the nature, objects and scheme of the legislation, and in the light of that examination must consider what is the exact area over which powers are given by the section under which the competent authority purports to act."[8]

On this approach nothing turns on the catchy and flashy word "sham" or "device".

The Court, in *Azadi Bachao,* raised a point that could not be at issue for obvious reasons. It observed:

> "They (the respondents) contend that this Court should interdict such arrangements and as if by waving a magic wand, bring about a situation where the incorporation becomes *non est*."

The administrative act of a foreign jurisdiction could not have been impeached in our domestic court. Our courts could not be invited to render the factum of

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[4]. (1985) 154 ITR 148 SC.
[5]. Dias, *Jurisprudence* 5th ed p. 126.
[6]. O. Hood Phillips' *Constitutional and Administrative Law* 7th ed. P. 662.
[7]. Per Lord Greene M.R. in *Carltona Ltd v. Commissioners of Works,* [1943] 2 All ER 560, 564.
[8]. Per Sachs J., *Commissioners of Customs and Excise v. Cure and Deeley Ltd*., [1962] 1 Q.B. 340.

the incorporation of a company in Mauritius *non est*. *Oppenheim* observes that there "is probably no international judicial authority in support of the proposition that recognition of foreign official acts is affirmatively prescribed by international law."[9] But it is an established principle of Public International Law that a State is competent to examine whether a foreign official having the domestic effect accords with the law before it recognizes it valid in its own jurisdiction. The International Court of Justice in *Nottebhom's Case*[10] held that "a State cannot claim that the rules [pertaining to the acquisition of nationality] are entitled to recognition by another State unless it has acted in conformity with this general aim of making the legal bond of nationality accord with the individual's genuine connection with the State which assumes the defence of its citizens by means of protection as against other States".

The Hon'ble Court observed: "…it is argued that *McDowell* has changed the concept of fiscal jurisprudence in this country and any tax planning which is intended to and results in avoidance of tax must be struck down by the Court." This topic has been discussed in the Chapter "Paradigm Shift in Tax Jurisprudence." It is felt, perish the thought, that the Court shares the post-welfare state ethos characterized by the rollback of the governmental activities and a consequent change of attitude to tax law.

II

1. *McDowell* when properly read

In *Azadi Bachao*, the Court read *McDowell*, it is most respectfully submitted, in a way no judgment is to be read. Instead of (i) proper inductions from the actual decision in that case, or (ii) examination and determination of the *ratio decidendi* contained therein, the Court focused only on—

(a) examining whether Justice Chinnappa Ready was correct in his views on certain *dicta* of Lord Tomlin in *IRC v. Duke of Westminster*[11], and how this decision fared in certain other decisions in India and England, and

(b) examining how much "a far cry" exists *inter se* the views of Justice Ranganath Misra (for himself and on behalf of Y.V. Chandrachud, C.J., and D. A. Desai and E.S. Venkataramiah, JJ) and that of Justice Reddy in the matter of tax avoidance.

Whilst conventionally the *material facts test* and *reversal test* are applied to determine the principles which a case brings out, this author believes that a better method (approximating the approach of I.A. Richards and C.K. Ogden in *The*

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[9]. Section 112.
[10]. ICJ Report (1955) at p. 23.
[11]. [1935] ALL ER Rep 259.

Meaning of Meaning) would have been be to read *McDowell* in the light of what the *Mimansa* tells us:

(The author renders in English this *sloka* thus) :

There may be seven ways to read a book:
First and second, concentrate on the threads
which unite the beginning and the end;
Third, is what is said again and again;
Fourth, is what is new therein,
Fifth, is the targeted consequence
Sixth, is what is mere peripheral
And the last is the logic, either supporting or countering.

It says that in order to comprehend the meaning and import of a book, seven determiners should be taken into account. First, what is the central strand in the thematic structure of a piece of work directly connecting the beginning to the end? Second element is the *purpose* revealing itself even through tone and tenor. Third element is what is suggested through variations on the core ideas. Fourth element is the quest to discover what is new (as any great work is intended to venture something new). Fifth element is the consequence, and its impact on public interest. Sixth element is constituted by the illustrative fillers, analogical reasoning, and supportive references. The incorrectness of materials in this sixth category, being merely illustrative fillers, may not have any bearing on the central meaning.[12] The seventh is the thrust of reasoning for and against the position adopted.

It is seen that the *upakrama* (the threshold situation) *and upsamhara* (conclusion) of the cause before the Court are only in the main judgment of *McDowell* delivered by Ranganath Misra J. on behalf of Chandrachud C.J., Desai, Venkataramiah and Ranganath Misra J. In the *upakrama,* material points were these:

(a) Purchasers of Indian liquors for obtaining distillery passes paid excise duty under Excise Rules. Under the governing law it was includible in the turnover of the manufacturer of liquor. Excise duty though paid by the purchaser to meet the liability of the manufacturer, is a part of the consideration for the sale and is includible in the turnover of the manufacturer. The purchaser has paid the tax on behalf of the manufacturer. In terms of the law the manufacturer was liable to pay excise duty on the manufacture of liquor. The excise duty paid on his behalf was integral to the consideration for the sale of liquor.

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12. Tilak, *The Geeta Rahashya* p.22.

(b) The assessee devised a way not to pay tax on turnover inclusive of duty paid by the liquor purchasers. The strategy was the conjoint product of two facts:

(i) under an agreed strategy the purchasers had to discharge the manufacture's liability; and

(ii) under this system the transactions of such payments were not made to figure in the assessee's books of accounts; it was stage-managed not to be part of the assessee's trade.

It was held that the fact that excise duty does not go into the common till of the manufacturer (assessee) to become a part of the circulating capital, is not the decisive test for determining whether such duty constitutes the seller's turnover.

As to *upsamhara* (conclusion) is the final outcome of the case when after determining the facts, and ascertaining the law, the latter is applied to the former. In this case Misra J succinctly states the legal perspective under which the facts were appraised. He observed:

> "Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable 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. On this aspect one of us, Chinnappa Reddy J., has proposed a separate and detailed opinion with which we agree."

It is submitted that it must be a mistake in comprehension which led the Court to hold in *Azadi Bachao* that there was "a far cry" between the views of Justice Reddy and Justice Misra; or to hold that Justice Reddy's view 'militated" against the view taken by his other four brother Judges. In fact the quotation from Justice Misra's judgment says precisely what Justice Reddy said in detail with flourish and solemn judicial passion. "Colourable" in the expression "colourable device" would mean "Pretended, feigned, counterfeit" *[The New SOD]*. As to "dubious": "Something that is dubious is not considered to be completely honest or safe, and therefore cannot be trusted or approved of. *[Collins Cobuild English Language Dictionary*]. And subterfuge means, as *Cobuild* says: 'A *subtrerfuge* is a trick or deceitful way of getting what you want". Justice Reddy in his supplemental judgment has said nothing more, nothing less.

Third element in discovery of meaning as per *Mimansa* is the core ideas coming up again and again in different ways as such ideas have generally a gripping presence in the mind of the writer. A close reading of the main and supplemental judgments shows that through points-counterpoints judicial displeasure at tax avoidance has been expressed. This judicial mission is so patent that culling of illustrations to prove it is not needed. But it is important to know the judicial philosophy of this approach. The main judgment touches this point, but it has been developed in the supplemental judgment wherein Justice Reddy, after enumerating

the evil consequences of tax avoidance, articulated a new judicial approach. The evil consequences highlighted include the following:

(i) First, there is substantial loss of much needed public revenue, particularly in a welfare State like ours.

(ii) Next, there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation.

(iii) Then there is "the large hidden loss" to the community (as pointed out by Master Sheatcroft in 18 Modern Law Review 209) by some of the best brains in the country being involved in the perpetual war waged between the tax-avoider and his expert team of advisers, lawyers and accountants on one side and the tax-gatherer, and his perhaps not so skillful advisers on the other side.

(iv) Then again there is the 'sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it'.

(v) Last but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guileless good citizens from those of the 'artful dodgers'.

And Justice Reddy states the judicial duty of the court thus:

> "It may, indeed, be difficult for lesser mortals to attain the state of mind of Mr. Justice Holmes, who said, "Taxes are what we pay for civilized society. I like to pay taxes. With them I buy civilization." But, surely, 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 recognize that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it. A hint of this approach is to be found in the judgment of Desai, J. in *Wood Polymer Ltd. and Bengal Hotels Limited*, (1977) 47 Com Cas 597 (Guj) where the learned Judge refused to accord sanction to the amalgamation of companies as it would lead to avoidance of tax."

Justice Reddy's views accord with our Constitution that attempts to build a welfare state. But this complex topic would be dealt with in a separate chapter on the Role of Judiciary.

The fourth element involves the discovery of what is new in a book (here, in the judgment). The very tenor of the judgment shows that it is not a mere application of law to facts. Its novelty is the juristic creation of legal perspective in tune with our Constitution. The judges adopted a historical perspective under which Lord Tomlin's ideas expressed in the *Duke of Westminster* had become anachronistic and unfair.

The fifth element is to consider the *effect* of a particular act, whether of a book or a judgment. The outcome in *McDowell* is a fair determination of tax liability by frustrating a strategy to dodge the law.

Arthwad is a technical concept in *Mimansa.* Often, once the heart of the matter is clear, an author resorts to illustrations and comparisons, and mentions many matters of peripheral and incidental relevance. In the *arthwad* the author is often not very particular about accuracy and exactness. The fatal flaw in the Court's exposition of *McDowell* in *Azadi Bachao* is not to notice what is mere *arthwad.* The entire criticism of *McDowell* boils down to one point only: that Justice Reddy was wrong in his assessment of Lord Tomlin's dictum in *IRC v. Duke of Westminster*[13]. Though the Bench avows its objective to "consider in some detail as to why *McDowell's case* [1985] 154 ITR 148 (SC), what it says, and what it does not say", it remains throughout engrossed with what was surely not the heart of the matter. The words of Lord Sumner in *IRC v. Fisher's Executors*[14] were quoted:

> "My Lords, the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any expressed terms or of any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame."

It was further pointed out that similar views were expressed by Lord Tomlin in *IRC v. Duke of Westminster* that reflected the prevalent attitude towards tax avoidance:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however, unappreciative the Commissioners of Inland Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax."

The Court observed that these ideas were the pre-Second World War sentiments expressed by the British courts. The Court in *Azadi Bachao* says:

> "It is urged that *McDowell's case* has taken a new look at fiscal jurisprudence and "the ghost of *Fisher's case* and *Westminster's case* have been exercised in the country of its origin". It is also urged that McDowell's case radical departure was in tune with the changed thinking on fiscal jurisprudence by the English courts, as

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13. [1936] AC 1 (HL); 19 TC 490, 520 (HL).
14. [1926] AC 395 at 412 (HL).

evidenced in *W.T. Ramsay Ltd. v. IRC*[15], *Inland Revenue Commissioners v. Burmah Oil Company Ltd*[16] and *Furniss v. Dawson*[17]."

And the whole judicial pursuit is to show that far from being exorcised in its country of origin, *Duke of Westminster's case* continues to be alive and kicking in England. But this point relating to *Duke of Westminster* is mere perpheral, a mere *arthwad.* Tilak, explaining *arthwad*, says; "Even if not totally out of context, things are referred to add weight or clarity. Such things may not even be always correct"[18].

The seventh element under the *Mimansa* principle of interpretations is *uppapatti*, which means criticizing what appears to go against a proposed view. Justice Reddy tried to place ideas under historical perspective. Time itself is a distinguishing factor. He reflects on the march of the law against tax avoidance schemes. F W Maitland wrote to Dicey that the only direct utility of legal history lies in the lesson that each generation has an enormous power of shaping its own law.[19] He refers to the celebrated dictum of Lord Simon in *Latilla v. Inland Revenue Commissioners*[20], and many other decisions. He rejects contrary ideas stated in *A. Raman and Co*[21], and *Commr. of Income-tax, Gujarat v. Kharwar*[22]. Misra J. takes note of a lot of cases including the decision of the Privy Council in *Bank of Chettinad Ltd. v. Commr. of Incometax.*[23]

2. Ratio Analysis

It is well known that the law declared by the Supreme Court is to be found in the ratio of a case. Lord Denning said: "We can only accept a line of reasoning which supports the actual decision of the House of Lords."[24] Critically examined the *upakrama* and *upsamhara* of *McDowell* reflects its *ratio.* It can be discovered either by "reversal test" or by "the material facts test". In the former, we take proposition of law put forward by the judge, reverse or negate it, and then see if its reversal would have altered the actual decision. Under the "material facts" test, the *ratio* is to be determined by ascertaining the facts treated as material by the judge together with the decision on those facts. A manufacturer of liquor is liable to pay duties, which, even if paid by the purchaser on his behalf, enters into the manufacturer's turnover. Bereft of details, in *McDowell* an arrangement of transaction was so done that the only effect was avoidance of tax. It was structured to conform to the law if the legal identities of apparently *dressed-up* transactions

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15. [1982] AC 300.
16. [1982] Simon's Tax Cases 30.
17. [1984] 1 All ER 530 (HL).
18. Tilak, *Geeta Rahashya* 27tgh ed. p. 22.
19. Cosgrove *The Rule of Law: Albeit Venn Dicey: Victorian Jurist* (1980) p 177.
20. 1943 AC 377.
21. AIR 1968 SC 49.
22. AIR 1969 SC 812.
23. AIR 1940 PC 183.
24. In re *Harper v. N.C.B* (1974) 2 w.l,r. 775.

alone were seen. The Hon'ble Court explored the operative realities, determined the true nature of the transactions, and gave legal effect to what emerged in true form. This would be clear from what the majority Judgment says:

> "According to Mr. Sorabji the excise duty had never come into the hands of the appellant and the Company had no occasion or opportunity to turn it over in its hands, and, therefore, the same could never be considered as a part of its turnover. The observations made by this Court were in a very different setting and what was being considered was whether the additional tax levied under the Madras Act formed a part of the turnover. If we accept the observations of Hidayatullah, J. as laying down the test for general application, it would be very prejudicial to the Revenue as between the seller and the buyer, by special arrangement, a part of what ordinarily would constitute consideration proper could even be kept out and the turnover could be reduced and tax liability avoided. We are of the view that the conclusion reached in the appellant's case in (1977) 1 SCR 914: (AIR 1977 SC 1459) on the second aspect of the matter, namely, when the excise duty does not go into the common till of the assessee and it does not become a part of the circulating capital, it does not constitute turnover, is not the decisive test for determining whether such duty would constitute turnover."

If through some device a situation is sought to be created which subverts right legal effect, the attempt must be frustrated. This exercise is to be done under a legal perspective which Justice Reddy explained at length in his supplemental judgment. This approach is stated with extreme precision by Misra J. in the paragraph already quoted. A judicial decision becomes, in the end, an exercise at construction involving the application of proper law on material facts. In effect the Court applied in *McDowell* the principles that were thus stated in the speech of Lord Nicholls in *MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd*[25]:

> "*Ramsay* brought out three points in particular. First, when it is sought to attach a tax consequence to transaction, the task of the courts is to ascertain the legal nature of the a transaction…
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> Second, this is not to treat a transaction, or any step in a transaction, as though it were a 'sham', meaning thereby, that it was intended to give the appearance of having a legal effect different from the actual legal effect intended by the parties: see the classic definition of Diplock LJ in *Snook v. London and West Riding Investments Ltd.*, [1967] 2 QB 786, 802. Nor is this to go behind a transaction for some supposed underlying substance. What this does is to enable the court to look at a document or transaction in the context to which it properly belongs.
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> Third, having identified the legal nature of the transaction, the courts must then relate this to the language of the statute. For instance, if the scheme has the apparently magical result of creating a loss without the taxpayer suffering any financial detriment, is this artificial loss a loss *within the meaning of the relevant statutory provision*? ……."

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[25]. [2001] 1 All ER 865 H.L.

It is submitted that in *Azadi Bachao* the Court, perhaps through an oversight, made serious mistakes in comprehending *I .R.C v. Duke of Westminster*[26]; and for that reason misunderstood the law declared by the Constitution Bench in *McDowell*. As from this miscomprehension emanated serious distortions in the judicial perspective producing a serious miscarriage of justice, it is worthwhile to mention the following:

(I) Justice Reddy's comments on the *Duke of Westminster* constitute what is called in *Mimansa* an '*arthvaad*' which comes in the sixth category. In *Azadi Bachao* the Court made too much of what, in fact, did not matter.

(II) *The Duke of Westminster* dealt with the construction of certain plain transactions where the Revenue had no reasons to doubt the *bona fides*. In *Furniss v Dawson*[27] Lord Bridge highlighted this point when he said:

> "The strong dislike expressed by the majority in the Westminster case [1936] AC 1 at 19… for what Lord Tomlin described as the doctrine that the Court may ignore the legal position and regard what is called "the substance of the matter" is not in the least surprising when one remembers that the only transaction in question was the duke's covenant in favour of the gardener and the *bona fides* of that transaction was never for a moment impugned". (Emphasis supplied)

In *Simon's Taxes* (3rd ed)[28] in the Chapter on "The Construction of Taxing Acts and Document" the following has been perceptively stated:

> "In the case discussed above there was no suggestion of bad faith, or that the particular form of the transaction was adopted as a cloak to conceal a different transaction. The documents in question were intended to be acted on, and were allowed by the parties to have their proper legal operation. Lord Tomlin stresses this fact in the *Westminister case.*[29] It is different where a deed or agreement is never meant to have effect, even in the absence of bad faith. Thus, where a member of a congregation of secular priests, acting as headmaster of a school established by the congregation, entered into a written agreement, under which he was entitled to a salary, but in fact received nothing, the agreement having been drawn up simply to comply with the requirements of the Board of Education, Finlay, J., held that the agreement did not represent the real bargain, or any bargain, between the parties. In this special case, therefore, the priest was not assessable under Schedule E.[30] It follows therefore that if the tribunal of fact finds, on proper evidence that a party setting up a transaction has not established that it was a genuine transaction carried through bona fide, it can have not effect for tax purposes.[31] No case or argument can be founded on a non-genuine basis. Thus, in Johnson V. Jewitt[32] a taxpayer attempted to create an artificial loss of a huge sum of money by creating and juggling with

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[26]. [(1926) A.C. 395].
[27]. [1984] 1 All ER 530 at p. 536.
[28]. at p 315.
[29]. [1936] A.C., at p. 20; 19 T.C., at p.521, H.L..
[30]. *Reade v. Brearley,* (1933), 17 T.C. 687; and see *Dickenson v. Gross,* (1927) 11 T.C.614.
[31]. *Kirby v. Steele,* (1946), 27 T.C. 370.
[32]. (1961), 40 T.C. 231, 253, C.A.

seventy-nine companies and so claim a large tax rebate. The transaction was held to be a complete sham:

"We were asked, what was this if it were not trading?…… I would call it a cheap exercise in fiscal conjuring and book-keeping phantasy, involving a gross abuse of the Companies Act and having as its unworthy object the extraction from the Exchequer of an enormous sum which the Appellant had never paid in tax and to which he has no shadow of a right whatsoever".[33]

From the above the following two seminal points emerge:

(a) *The Duke of Westminster* dealt with a *bona fide* situation; and

(b) The statement of Lord Tomlin involved an ambiguity. Ambiguity adds richness in poetry but is a blemish in legal prose. There was no need to resolve this ambiguity in the *Westminster* case, as the decision was absolutely right as it came within the principle stated by Lord Tomlin. Had Lord Tomlin faced a problem involving *a mask* he would have been the first to rip the mask off. His statement should not be construed as if it were a statute. Treaty Shopping is, on all juristic principle, a fraud. It is respectfully submitted that Treaty Shopping is not a *bona fide* situation.

(c) The ambiguity in Lord Tomlin's dictum, which bewildered many later judges, stands explained by Lord Hoffmann in *MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd.*

It deserves to be noted that in all the cases, to which the Hon'ble Court refers as approving *Duke of Westminster*, this fundamental difference (*bona fide* and *mala fide* situations) remained under the prime focus. The Privy Council in *Bank of Chettinad Ltd v. CIT*[34] was dealing with a *bona fide* situation clearly coming within the category to which the situation in the *Duke of Westminster* belongs. It examined facts to see whether there was a business connection within the meaning of the relevant provision under the Income-tax Act, 1922. The Privy Council held in favour of the Revenue. In *Mathuram Agrawal v. State of M.P.*[35] this Hon'ble Court referred to *Bank of Chettinad Ltd. v. Commr. of Income-tax* and *Inland Revenue Commissioner v. Duke West Minister* but *McDowell & Co Ltd v. CTO* was not even referred**.** The Hon'ble Court was considering matters relating to M .P. Municipalities Act (37 of 1961), S.127A (2)(b) to see whether certain provisions were *ultra vires* the charging section. The fact-situation was a *bona fide* situation involving statutory construction. The Constitution Bench in *Mathuram* said nothing about *McDowell*, though its awareness cannot be doubted. It presented a *bona fide* situation. In the case of *Bank of Chettinad Ltd. v. Commr. of Income-tax*, Madras, (AIR 1940 PC 183), the Privy Council quoted with approval

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33. Per Donovan, L.J., 40 T.C. 231, 255. Sell also *Johns v. Wirsal Securities, Ltd.*, (1966) 1 ALL E.R. 865; 43 T.C. 629.

34. AIR 1940 P.C. 183 [Lord Russell of Killowen, Sir Lancelot Sanderson, and Sir M.R. Jayakar].

35. AIR 2000 SC 109.

a passage from the opinion of Lord Russell of Killowen in *Inland Revenue Commissioners v. Duke of Westminster*, (1936) AC 1. The Hon'ble Court was not examining what should be the right judicial approach in a case involving a camouflage causing wrongful gains to the treaty-shoppers and wrongful loss the people of India. It was not a case wherein there is a clear evasion of reality.

It is submitted that by not resolving the ambiguity in Lord Tomlin's dictum the Hon'ble Court misdirected itself in law. Lord Tomlin's dictum is still valid in *X* situation, not the *Y* situation. . The effect of both *Craven v White* and *MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd* is that the view propounded by Lord Tomlin cannot be applied to the X situation; hence, to that extent, the rule is obviously dead in England. Hence, it is most respectfully submitted, that the principle in *Duke of Westminster* is surely alive and kicking in the country of its birth but only within the legitimate sphere of its operation i.e. to cover situation *X*, not situation *Y*.

It is humbly submitted that right from the day *McDowell* was decided by the Court, those who played truants with law were never comfortable with it. One petition had been moved before this Hon'ble Court for a reconsideration of the judgment (165 ITR St 225), but was not pursued. The flak that this great decision of the Constitution Bench received in the open Court is extremely worrisome. In the U.K. too the vested interests behaved no better. Hermann writes:

> "Sensing a certain softness and confusion in 1988 composition of the Judicial Committee of the House of Lords the tax lawyers renewed their attack under the flag of the Special Committee of Tax Consultative Bodies. The first two parts of their report on Tax Law after *Furniss v. Dawson* is a lament on the blow inflicted to tax avoidance industry, which will hardly bring me to tears".[36]

The laments of the tax lawyers promoting this industry, unworthy in the eyes of common people, went in vain in the U.K. as the House of Lords is yet to duck or ditch *Dawson*.

It is respectfully submitted that the Hon'ble Court misdirected itself in relying on the American law. American Jurisprudence rejects *motivation* as a ground for the rejection of a claim. In *Azadi Bachao* the question was not of *motivation* but of appropriate construction of the Income-tax Act and the terms of the Indo-Mauritius DTAC. It contemplates a *bona fide* situation. The whole confusion sprang up on account of the exclusion of the factual substratum of the case which the Petitioner sought to bring to the notice of the Hon'ble Court by producing before it the uncontroverted facts from the Assessment Order passed in the case *M/s Cox & King.* This exclusion distorted judicial perspective, as it was a clear breach of the rules of Natural Justice. The effect of *Duke of Westminster* and *Helvering* was thus stated by Lord Bridge in *Furniss v. Dawson*[37]:

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[36]. A.H. Hermann, *Law v. Business* p.17 (Butterworth).
[37]. [1984] 1 All ER 530 at 535.

"But in another sense the present appeal marks a further important step, as a matter of decision rather than as a matter of dictum, in the development of the court's increasingly critical approach to the manipulation of financial transactions to the advantage of the taxpayer. Of course, the judiciary must never lose sight of the basic premise expressed in the celebrated dictum of Lord Tomlin in *IRC v. Duke of Westminster*…. 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.'

Just a year earlier Learned Hand J, giving the judgment of the United States Second Circuit Court of Appeals in *Helvering v. Gregory* (1934) 69 F 2D 809, had said the same thing in different words:

'Anyone 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.'

Yet, while starting from this common principle, the federal courts of the United States and the English courts have developed, quite independently of any statutory differences, very different techniques for the scrutiny of tax avoidance schemes to test their validity".

3. Historical Perspective

The Court made serious mistake by not sharing the historical perspective which *McDowell* adopts. The most important point in *McDowell's* case is the recognition of TIME itself as a distinguishing factor in matter of interpretation. This approach brings to mind what Lord Buckmaster said in *Stag Line Ltd. v. Foscolo Mango & Co. Ltd*.[38] :

"It hardly needed the great authority of Lord Herschell in *Hick v. Raymond and Reid* (2) to decide that in constructing such a word it must be construed in relation to all the circumstances, for it is obvious that what may be reasonable under certain conditions may be wholly unreasonable when the conditions are changed. Every condition and every circumstance must be regarded, and it must be reasonable, too, in relation to both parties to the contract and not merely to one."

Justice Chinnappa Reddy in *McDowell's Case* observed:

"During the period between the two world wars, a theory came to be propounded and developed that it was perfectly open for persons to evade (avoid) income-tax if they could do so legally [39]…Then came World War II and in its wake huge profiteering and racketeering, something which persists till today, but on a much larger scale. The attitude of the courts towards avoidance of tax perceptibly changed and hardened…"

He referred to the observations but many eminent judges in many well-known cases, against tax avoidance. He quoted the observation of Lord Roskill in *Furniss v. Dawson* wherein the following had been observed:

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38. [1931] All ER Rep 666 H L.
39. 154 ITR 148 at 152.

> "The error, if I may venture to use that word, into which the courts below have fallen is that they have looked back to 1936 and not forward from 1982."

Azadi Bachao expresses the ethos of the post-welfare State phase, which has its own special features and a distinct perspective and observation-post. This aspect of the matter would be discussed in a separate chapter. The convoluted reasoning in many of the observations in *Norglen Ltd v. Reeds Rains Prudential Ltd.*,[40] and in *MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd.*,[41] evidence a patent shift in judicial observation-post striking a synchrony with the roll-back State in the present phase of economic globalization. They do not depart from the approaches approved in *Furniss* but they lack in perspicacity and sublime passion, which dominate *Furniss* and the other decisions illustrating the new judicial approach. Whilst in England it is possible for judiciary to depart from the fundamental postulates of the Welfare State, in India the constitutional commitments to evolve a Welfare State cannot be given up without going beyond the Constitution itself.

4. Judicial Role: *Causa causans*

What differentiates *Azadi Bachao* from *McDowell* is the perception of the ambit and reach of judicial role. This narrowing of judicial role in *Azadi Bachao* is a worrisome departure in this phase of globalization wherein our democratic polity and our Constitution both are up against sinister hazards posed by heartless predatory international financiers, and those gentlemen of the accounting profession whose feats of creativity are designed to promote the interests, worthy or unworthy, of a miniscule section of the haves. Referring to Chinnappa Reddy's ideas as to the judicial role, *Azadi Bachao* says:

> "This opinion of the majority [as stated in the para quoted in para 9 *supra*] is a far cry from the view of Chinnappa Reddy J.: "In our view the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether a provision should be construed literally or liberally nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it." We are afraid that we are unable to read or comprehend the majority judgment in McDowell's case [1985] 154 ITR 148 (SC) as having endorsed this extreme view of Chinnappa Reddy J., which, in our considered opinion, actually militates against the observations of the majority of the judges which we have just extracted from the leading judgment of Ranganath Mishra J."

What Justice Reddy has said about the creative role of the court is precisely what Lord Scarman observed in *Furnis v. Dawson*. This author has shown, on

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40. [1999] 2 AC 1.
41. [2001] I All ER p. 865, at 874; [2002] 255 ITR 612 at 623.

analysis of facts, that all other four Judges in *McDowell* agreed with what Justice Reddy said. It is distressing to note that this narrowing of the judicial view led the Court to make a mere *cri de Coeur* to the executive and legislature to provide a remedy against the fraud of Treaty-Shopping when the grant of this remedy was clearly within the province and function of judiciary itself. Role perception has an inevitable impact on judicial decision-making . A judicial decision provides a solution through insight. In discovering principles, in organizing resources, the perception of role is crucial. Every problem constitutes an external stimuli to which the deep well of the judge's mind makes response depending on numerous variables, psychological and functional. As this aspect of the matter requires a comprehension of judicial role under our Constitution, it would be examined in a separate chapter on the Role of Judiciary.

5. Judicial remedy against an *entente cordiale* of Collusion and Fraud

Azadi Bachai begins its exposition of "Rule in McDowell" with a sentence, which could be a part of the shadowboxing of the Appellants (the Union of India and a Mauritian company) rather than a plea of the Respondents (the PIL Petitioners). The said Judgment says:

> "The respondents strenuously criticized the act of incorporation by FIIs under the Mauritian Act as a "sham" and "a device" actuated by improper motives."

The author's whole case before the Court was founded on an assertion that Collusion and Fraud through their congeneric operation through an opaque system led the depredation on our country's economic resources to as a matter of natural consequence contributed to moral degradation and national insecurity. The plea was that, on analysis, Treaty Shopping is a conjoint product of *Collusion* and *Fraud*[42] *inter se* the vested interests in Mauritius and the residents of the third States. The strategy was crafted through a network of collusion. The dressed-up evidence presented by those who wanted to masquerade as the Mauritian residents before the income-tax authorities to obtain benefits of a bilateral tax treaty between India and Mauritius, was a stratagem of fraud to cause wrongful gains

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[42]. "In such a proceeding, the claim put forward is fictitious the contest over it unreal and the decree passed therein is mere mask having the similitude of a judicial determination and worn by the parties with the object of confounding third parties. But when a proceeding is alleged to be fraudulent, what is meant is that the claim made therein is untrue, but that claimant has managed to obtain the verdict of the Court in his favour and against his opponent by practicing fraud on the Court. Such a proceeding is started with a view to injure the opponent, and there can be no question of its having been initiated as a result of an understanding between the parties. While in the collusive proceedings the combat is mere sham, in a fraudulent suit it is real and earnest.

by inflicting wrongful loss on others."[43] As Comus was an offspring of Bacchus and Circe, a Treaty Shopping is fathered by Collusion and Fraud in Darkness.

Assuming *arguendo* that it was this author's case that the "incorporation" in Mauritius was a 'device' or 'sham', the principal plea went unnoticed with a disastrous consequence on the cause. "Incorporation" is a domestic legal act of Mauritius.In *Furniss v. Dawson*[44] the House of Lords ignored the existence of tax haven company for the purpose of tax law. As, in *Furniss* there was no economic impact of the transposed entity, its relevance was not recognized *for the purposes of the tax laws.* In *Knetsch v. United States*[45] the U.S Supreme Court shows that even legitimate corporation may engage in transactions lacking economic substance; and so the Commissioner could disregard transactions between related legitimate corporations. The 1986 decision of the Bundesfinanzhof in German jurisdiction: the doctrine of the abuse of legal form[46] has been recognized. Klaus Vogel has outlined the judicial perspective in these words[47]:

> "If the form of a transaction is not recognized for tax purposes under domestic law or under treaty law, the tax consequences which the tax payer sought to obtain through structuring the transaction in question will not occur and tax authorities will then apply those tax rules which would have applied according to the appropriate legal form of transaction…"

That the aforesaid facts show that a company can be a legal person without being a *resident* for the purpose of a tax convention.

III

6. The present status of *McDowell*

Technically speaking *Azadi Bachao*, being a decision by a Division Bench of two Judges cannot have any adverse impact on the rule in *McDowell*, a decision by the Constitution Bench, because if it does so, it would be to that extent *non est*.

As the supplemental judgment by Chinnappa Reddy is an integral part of the judicial decision in *McDowell*, any attempt at excision of Justice Reddy's opinion from the corpus of the judgment is a clear disrespect for the Supreme Court.

If the Division Bench, which decided *Azadi Bachao,* felt that Justice Reddy was not correct, the only course available to it was refer the matter to a larger Bench. It was beyond its competence to put its own gloss *de hors* the supplemental

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43. Wharton's *Law Lexicon* quoted by the Supreme Court in *Nagubai Ammal v. B. Shama Rao* AIR 1956 SC 593.
44. [1984] 1 All ER 530.
45. 364 US 361 (1960).
46. Philip Baker in *Double Taxation Conventions and International Law* 2 ED. p. 101.
47. *Klaus* Vogel *on Double Taxation Conventions* at pp. 41-42.

judgment with which the four other judges had not only agreed in specific terms, and had struck no note of discordance. This action was clearly an act without jurisdiction. The legal view, laconically expressed by Misra J (alredy quoted above), is itself enough to play the Lancelot for Revenue.

McDowell is most often relied as an authority for exploring the operative realities of a case suspected to have resorted to tax fraud. In *Azadi Bachao* the Court had recognized the operation of the doctrine of the Lifting of the Corporate Veil only in domestic law. The judicial observation on this point has been discussed in detail in the Chapter on "A Corporation cannot be an impervious coverlet of gross abuse". However, it is worthwhile to make the following comments:

(i) *F.G. (Films) Ltd., In re* is a classic case empowering the revenue authorities to protect revenues from the tax dodgers and fraudsters. None is entitled to deceive the authorities by putting on mask.

(ii) The Court went wrong in stating: "There is no doubt that, where necessary, the courts are empowered to lift the veil of incorporation *while applying the domestic law*." [Italics supplied]. God knows wherefrom the Court got it that the doctrine of the lifting of the corporate veil apples only within a domestic jurisdiction. This judicially created doctrine to applies to the whole judicial making process[48]. Secondly, it missed that even the International Court of Justice explores operative realities, and this doctrine is invoked even in international jurisprudence[49].

(iii) The judicial view that "the whole purpose of the DTAC is to ensure that the benefits thereunder are available even if they are inconsistent with the provisions of the Indian Income-tax Act" goes against law and principle (as this author would state in a separate chapter).

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48. *CIT v. Sri Meenakshi Mills Ltd*., AIR 1967 SC 819 ; *New Horizons Ltd. v. Union of India*, [1995] 1 SCC 478 ; *State of UP v. Renusagar Power Company*, [1988] 4 SCC 59.

49. *In the North Sea Continental Shelf Case* ICJ 1969, 3 at 222.; *Nottebhom's Case* ICJ Report (1955) at p. 23.