Case Citation: (2017) ibclaw.in 1313 SC

CASE NO.:
Appeal (civil) 8161-8162 of 2003
Appeal (civil) 8163-8164 of 2003

PETITIONER:
Union of India and Anr.

RESPONDENT:
Azadi Bachao Andolan and Anr.

DATE OF JUDGMENT: 07/10/2003

BENCH:
Ruma Pal & B.N. Srikrishna.

JUDGMENT:
J U D G M E N T

(Arising out of S.L.P.(C) Nos.20192-20193 of 2002)
(@ S.L..P.(C) Nos. 22521-22522 of 2002)

SRIKRISHNA,J.

Leave granted.

These appeals by special leave arise out of the judgment of the Division Bench of Delhi High Court allowing Civil Writ Petition (PIL)No.5646/2000 and Civil Writ Petition No.2802/2000. The High Court by its judgment impugned in these appeals quashed and set aside the circular No.789 dated 13.4.2000 issued by the Central Board of Direct Taxes (hereinafter referred to as "CBDT") by which certain instructions were given to the Chief Commissioners/Directors General of Income-tax with regard to the assessment of cases in which the Indo - Mauritius Double Taxation Avoidance Convention, 1983 (hereinafter referred to as 'DTAC') applied. The High Court accepted the contention before it that the said circular is ultra vires the provisions of Section 90 and Section 119 of the Income-tax Act, 1961(hereinafter referred to as 'the Act') and also otherwise bad and illegal.

It would be necessary to recount some salient facts in order to appreciate the plethora of legal contentions urged.

FACTS

A: The Agreement

The Government of India has entered into various Agreements (also called Conventions or Treaties) with Governments of different countries for the avoidance of double taxation and for prevention of fiscal evasion. One such Agreement between the Government of India and the Government of Mauritius dated April 1, 1983, is the subject matter of the present controversy. The purpose of this Agreement, as specified in the preamble, is "avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment". After completing the formalities prescribed in Article 28 this agreement was brought into force by a Notification dated 6.12.1983 issued in exercise of the powers of the Government of India under Section 90 of the Act read with Section 24A of the Companies (Profits) Surtax Act, 1964. As stated in the Agreement, its purpose is to avoid double taxation and to encourage mutual trade and investment between the two countries, as also to bring an

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environment of certainty in the matters of tax affairs in both countries.

Some of the salient provisions of the Agreement need to be noticed at this juncture. The Agreement defines a number of terms used therein and also contains a residuary clause. In the application of the provisions of the Agreement by the contracting States any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws in force in that contracting State, relating to the words which are the subject of the convention. Article 1(e) defines 'person' so as to include an individual, a company and any other entity, corporate or non-corporate "which is treated as a taxable unit under the taxation laws in force in the respective contracting States". The Central Government in the Ministry of Finance (Department of Revenue), in the case of India, and the Commissioner of Income Tax in the case of Mauritius, are defined as the "competent authority". Article 4 provides the scope of application of the Agreement. The applicability of the Agreement is determined by Article 4 which reads as under;

"Article 4 Residents

1. For the purposes of the Convention, the term "resident of a Contracting State" means any person who under the laws of that State, is liable to taxation therein by reason of his domicile, residence, place or management or any other criterion of similar nature. The terms "resident of India" and "resident of Mauritius" shall be construed accordingly.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his residential status for the purposes of this Convention shall be determined in accordance with the following rules:

(a) he shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (hereinafter referred to as his "centre of vital interests");

(b) if the Contracting State in which he has his centre of vital interest cannot be determined, or if he does not have a permanent home available to him in either Contracting State he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;

(c) if he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;

(d) if he is a national of both Contracting

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States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provision of paragraph 1, a person other than an individual is a resident of both the Contracting States, then it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated."

The Agreement provides for allocation of taxing jurisdiction to different contracting parties in respect of different heads of income. Detailed rules are stipulated with regard to taxing of Dividends under Article 10, interest under Article 11, Royalties under Article 12, Capital Gains under Article 13, income derived from Independent Personal Services in Article 14, income from Dependent Personal Services in Article 15, Directors' Fees in Article 16, income of Artists and Athletes in Article 17, Governmental Functions in Article 18, income of students and Apprentices in Article 20, income of Professors, Teachers and Research Scholars in Article 21, and other income in Article 22.

Article 13 deals with the manner of taxation of capital gains. It provides that gains from the alienation of immovable property may be taxed in the Contracting State in which such property is situated. Gains derived by a resident of a Contracting State from the alienation of movable property, forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment, may be taxed in that other State. Gains from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the Contracting State in which the place of effective management is situated. With respect to capital gain derived by a resident in the Contracting State from the alienation of any property other than the aforesaid is concerned, it is taxable only in the State in which such a person is a 'resident'.

Article 25 lays down the Mutual Agreement Procedure. It provides that where a resident of a Contracting State considers that the actions of one or both of the Contracting State result or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident. This case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Convention. Thereupon, if the objection appears to be justified, the competent authority shall attempt to resolve the case by mutual agreement with the competent authority of the other Contracting State so as to avoid a situation of taxation not in accordance with the convention. This Article also provides for endeavour by the competent authorities of the Contracting States to resolve by mutual agreement any difficulties or doubts arising as the interpretation or application of the convention. For this purpose, the convention contemplates continuous or periodical communication between the competent authorities of the Contracting States and exchange of views and opinions.

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B : The Circulars
By a Circular No.682 dated 30.3.1994 issued by the CBDT in exercise of its powers under Section 90 of the Act, the Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India. Relying on this, a large number of Foreign Institutional Investors s (hereinafter referred to as "the FIIs"), which were resident in Mauritius, invested large amounts of capital in shares of Indian companies with expectations of making profits by sale of such shares without being subjected to tax in India. Sometime in the year 2000, some of the income tax authorities issued show cause notices to some FIIs functioning in India calling upon them to show cause as to why they should not be taxed for profits and for dividends accrued to them in India. The basis on which the show cause notice was issued was that the recipients of the show cause notice were mostly 'shell companies' incorporated in Mauritius, operating through Mauritius, whose main purpose was investment of funds in India. It was alleged that these companies were controlled and managed from countries other than India or Mauritius and as such they were not "residents" of Mauritius so as to derive the benefits of the DTAC. These show cause notices resulted in panic and consequent hasty withdrawal of funds by the FIIs. The Indian Finance Minister issued a Press note dated April 4, 2000 clarifying that the views taken by some of the income-tax officers pertained to specific cases of assessment and did not represent or reflect the policy of the Government of India with regard to denial of tax benefits to such FIIs.
Thereafter, to further clarify the situation, the CBDT issued a Circular No.789 dated 13.4.2000. Since this is the crucial Circular, it would be worthwhile reproducing its full text. The Circular reads as under:

"Circular No.789

F.No.500/60/2000-FTD
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF REVENUE
CENTRAL BOARD OF DIRECT TAXES

New Delhi, the 13th April, 2000

To

All the Chief Commissioners/ Directors
General of Income-tax

Sub: Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC) - Reg.

The provisions of the Indo-Mauritius DTAC of 1983 apply to 'residents' of both India and Mauritius . Article 4 of the DTAC defines a resident of one State to mean any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. Foreign Institutional Investors and other investment funds etc. which are operating from Mauritius are invariably incorporated in that country. These entities are 'liable to tax'

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under the Mauritius Tax law and are therefore to be considered as residents of Mauritius in accordance with the DTAC.

Prior to 1st June, 1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend paid out at the rate of 5% or 15% depending upon the extent of shareholding of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.

The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

The aforesaid clarification shall apply to all proceedings which are pending at various levels."

C: The Writ Petitions

Circular No. 789 was challenged before the High Court of Delhi by two writ petitions, both said to be by way of Public Interest Litigation. The petitioner in CWP 2802 of 2000 (Azadi Bachao Andolan) prayed for quashing and declaring as illegal and void Circular No.789 dated 13.4.2000 issued by the CBDT. The petitioner in CWP 5646 of 2000 sought an appropriate direction/order or writ to the Central Government and made the following prayers:

"(a) issue such appropriate direction /order / writ as the Court deem proper, under the circumstances brought to the knowledge of the Hon'ble Court, to the Central Government to initiate a process whereby the terms of the Indo-Mauritius Double Taxation Avoidance Agreement are revised, modified, or terminated and /or effective steps taken by the High Contracting Parties so that the NRIs and FIIs and such other interlopers do not maraud the resources of the State.

(b) declare and delimit the powers of the Central Government under section 90 of the Income Tax Act, 1961 in the matter of entering into an agreement with the Government of any country outside India;

(c) declare and delimit the powers of the Central Board of Direct Taxes in the matter of the

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issuance of instructions through circulars to the statutory authorities under the Income tax Act, specially through such circulars which are beneficial to certain individual taxpayers but injurious to Public Interest.

(d) declare the illegality of Circular No.789 of April 13, 2000 issued by the Central Board of Direct Taxes and to quash it as a matter of consequence;

(e) issue mandamus so that the respondents discharge their statutory duties of conducting investigation and collection of tax as per law;

(f) issue appropriate direction/ order or writ of the nature of mandamus, as the Court deem fit, so that all remedial actions to undo the effects of the acts done to the prejudice or Revenue in pursuance of Circular No.789 are taken by the authorities under the Income tax Act, 1961"

D : High Court's findings

The High Court has quashed the circular on the following broad grounds:

(A) Prima facie, by reason of the impugned circular no direction has been issued. The circular does not show that it has been issued under section 119 of the Income-tax Act, 1961 and as such it would not be legally binding on the Revenue;

(B) The Central Board of Direct Taxes cannot issue any instruction, which would be ultra vires the provisions of the Income-tax Act, 1961. Inasmuch as the impugned circular directs the income-tax authorities to accept a certificate of residence issued by the authorities of Mauritius as sufficient evidence as regards status of resident and beneficial ownership, it is ultra vires the powers of the CBDT;

(C) The Income-tax Officer is entitled to lift the corporate veil in order to see whether a company is actually a resident of Mauritius or not and whether the company is paying income-tax in Mauritius or not and this function of the Income-tax Officer is quasi-judicial. Any attempt by the CBDT to interfere with the exercise of this quasi-judicial power is contrary to intendment of the Income-tax Act.

(D) Conclusiveness of a certificate of residence issued by the Mauritius Tax Authorities is neither contemplated under the DTAC, nor under the Income-tax Act; whether a statement is conclusive or not, must be provided under a legislative enactment such as the Indian Evidence Act and cannot be determined by a mere circular issued by the CBDT;

(E) "Treaty Shopping", by which the resident of a third country takes advantage of the provisions of the Agreement, is illegal and thus necessarily forbidden;

(F) Section 119 of the Income-tax Act, 1961 enables the issuance of a circular for a strictly limited purpose. By a circular issued thereunder, neither can the essential legislative function be delegated, nor arbitrary, uncanalized or naked power be conferred;

(G) Political expediency cannot be a ground for not fulfilling the constitutional obligations inherent in the Constitution of India and reflected in section 90 of the Act. The circular confers power to lay down a law which is not contemplated under the Act on the ground of political expediency, which cannot but be ultra vires.

(H) Any purpose other than the purpose contemplated by section 90 of the Act, however bona fide it be, would be ultra vires the provisions of section 90 of the Income tax Act.

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(I) While political expediency will have a role to play in terms of Article 73 of the Constitution, the same is not true when a Treaty is entered into under the statutory provision like section 90 of the Act.
(J) Avoidance of double taxation is a term of art and means that a person has to pay tax at least in one country; avoidance of double taxation would not mean that a person does not have to pay tax in any country whatsoever.
(K) Having regard to the law laid down by the Supreme Court in McDowell & Company v C.T.O , it is open to the Income-tax Officer in a given case to lift the corporate veil for finding out whether the purpose of the corporate veil is avoidance of tax or not. It is one of the functions of the assessing officer to ensure that there is no conscious avoidance of tax by an assessee, and such function being quasi-judicial in nature, cannot be interfered with or prohibited. The impugned circular is ultra vires as it interferes with this quasi judicial function of the assessing officer.

(L) By reason of the impugned circular the power of the assessing authority to pass appropriate orders in this connection to show that the assessee is a resident of a third country having only paper existence in Mauritius, without any economic impact, only with a view to take advantage of the double taxation avoidance agreement, has been taken away.
THE SUBMISSIONS
The learned Attorney General and Mr. Salve, for the appellants, have assailed the judgment of the Delhi High Court on a number of grounds, while the respondents through Mr.Bhushan, and in person, reiterated their submissions made before the High Court and prayed for dismissal of these appeals.

Purpose and consequence of Double Taxation Avoidance Convention

To appreciate the contentions urged, it would be necessary to understand the purpose and necessity of a Double Taxation Treaty, Convention or Agreement, as diversely called. The Income-tax Act, 1961, contains a special Chapter IX which is devoted to the subject of 'Double Taxation Relief". Section 90, with which we are primarily concerned, provides as under:

"90. Agreement with foreign countries.
(1) The Central Government may enter into an agreement with the Government of any country outside India-

(a) for the granting of relief in respect of income on which have been paid both income-tax under this Act and income-tax in that country, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this

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Act and under the corresponding law in force in that country,

and may, by notification in the Official Gazette, make provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

(Explanation omitted as not relevant)

Section 4 provides for Charge of Income-tax. Section 5 provides that the total income of a resident includes all income which : (a) is received, deemed to be received in India or (b) accrues, arises or deemed to accrue or arise in India, or (c) accrues or arises outside India, during the previous year. In the case of a non-resident, the total income includes "all income from whatever source derived" which (a) is received or is deemed to be received or, (b) accrues or is deemed to accrue in India, during such year. A person 'resident' in India would be liable to income-tax on the basis of his global income unless he is a person who is 'not ordinarily' resident within the meaning of section 6(b). The concept of residence in India is indicated in section 6. Speaking broadly, and with reference to a company, which is of concern here, a company is said to be 'resident' in India in any previous year, if it is an Indian company or if during that year the control and management of its affairs is situated wholly in India.

Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of the taxable entity, maintenance of a permanent establishment, and so on. A country might choose to emphasise one or the other of the aforesaid factors for exercising fiscal jurisdiction to tax the entity. Depending on which of the factors is considered to be the connecting factor in different countries, the same income of the same entity might become liable to taxation in different countries. This would give rise to harsh consequences and impair economic development. In order to avoid such an anomalous and incongruous situation, the Governments of different countries enter into bilateral treaties, Conventions or agreements for granting relief against double taxation. Such treaties, conventions or agreements are called double taxation avoidance treaties, conventions or agreements.

The power of entering into a treaty is an inherent part of the sovereign power of the State. By article 73, subject to the provisions of the Constitution, the executive power of the Union extends to the matters with respect to which the Parliament has power to make laws. Our Constitution makes no provision making legislation a condition for the entry into an international treaty in time either of war or peace. The executive power of the Union is vested in the President and is exercisable in accordance with the Constitution. The Executive is qua the State competent to represent the State in all matters international and may by agreement, convention or treaty incur obligations which in international law are binding upon the State. But the obligations arising under the

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agreement or treaties are not by their own force binding upon Indian nationals. The power to legislate in respect of treaties lies with the Parliament under entries 10 and 14 of List I of the Seventh Schedule. But making of law under that authority is necessary when the treaty or agreement operates to restrict the rights of citizens or others or modifies the law of the State. If the rights of the citizens or others which are justiciable are not affected, no legislative measure is needed to give effect to the agreement or treaty.

When it comes to fiscal treaties dealing with double taxation avoidance, different countries have varying procedures. In the United States such a treaty becomes a part of municipal law upon ratification by the Senate. In the United Kingdom such a treaty would have to be endorsed by an order made by the Queen in Council. Since in India such a treaty would have to be translated into an Act of Parliament, a procedure which would be time consuming and cumbersome, a special procedure was evolved by enacting section 90 of the Act.

The purpose of section 90 becomes clear by reference to its legislative history. Section 49A of the Income-tax Act, 1922 enabled the Central Government to enter into an agreement with the government of any country outside India for the granting of relief in respect of income on which, both income-tax (including super-tax) under the Act and income-tax in that country, under the Income-tax Act and the corresponding law in force in that country, had been paid. The Central Government could make such provisions as necessary for implementing the agreement by notification in the Official Gazette. When the Income-tax Act, 1961 was introduced, section 90 contained therein initially was a reproduction of section 49A of 1922 Act. The Finance Act, 1972 (Act 16 of 1972) modified section 90 and brought it into force with effect from 1.4.1972. The object and scope of the substitution was explained by a circular of the Central Board of Taxes (No.108 dated 20.3.1973) as to empower the Central Government to enter into agreements with foreign countries, not only for the purpose of avoidance of double taxation of income, but also for enabling the tax authorities to exchange information for the prevention of evasion or avoidance of taxes on income or for investigation of cases involving tax evasion or avoidance or for recovery of taxes in foreign countries on a reciprocal basis. In 1991, the existing section 90 was renumbered as sub-section(1) and sub-section(2) was inserted by Finance Act, 1991 with retrospective effect from April 1, 1972. CBDT Circular No. 621 dated 19.12.1991 explains its purpose as follows:

"Taxation of foreign companies and other non-resident taxpayers -

43. Tax treaties generally contain a provision to the effect that the laws of the two contracting States will govern the taxation of income in the respective State except when express provision to the contrary is made in the treaty. It may so happen that the tax treaty with a foreign country may contain a provision giving concessional treatment to any income as compared to the position under the Indian law existing at that point of time. However, the Indian law may subsequently be amended, reducing the incidence of tax to a level lower than what has been provided in the tax treaty.

43.1. Since the tax treaties are intended to grant tax relief and not put residents of a contracting country at a disadvantage vis-Ã -vis

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other taxpayers, section 90 of the Income-tax Act has been amended to clarify that any beneficial provision in the law will not be denied to a resident of a contracting country merely because the corresponding provision in the tax treaty is less beneficial."

The provisions of Sections 4 and 5 of the Act are expressly made "subject to the provisions of this Act", which would include Section 90 of the Act. As to what would happen in the event of a conflict between the provision of the Income-tax Act and a Notification issued under Section 90, is no longer res-integra.

The Andhra Pradesh High Court in Commissioner of Income Tax v. Visakhapatnam Port Trust held that provisions of section 4 and 5 of Income-tax Act are expressly made 'subject to the provisions of the Act' which means that they are subject to provisions of section 90. By necessary implication, they are subject to the terms of the Double Taxation Avoidance Agreement, if any, entered into by the Government of India. Therefore, the total income specified in Sections 4 and 5 chargeable to income tax is also subject to the provisions of the agreement to the contrary, if any.

In Commissioner of Income Tax v. Davy Ashmore India Ltd. , while dealing with the correctness of a circular no.333 dated April 2, 1982, it was held that the conclusion is inescapable that in case of inconsistency between the terms of the Agreement and the taxation statute, the Agreement alone would prevail. The Calcutta High Court expressly approved the correctness of the CBDT circular No.333 dated April 2, 1982 on the question as to what the assessing officers would have to do when they found that the provision of the Double Taxation was not in conformity with the Income-tax Act, 1961. The said circular provided as follows (quoted at p.632):

"The correct legal position is that where a specific provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Income-tax Act, 1961. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government under section 90 of the Income-tax Act, 1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the Agreement.

Thus, where a Double Taxation Avoidance Agreement provided for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act. Where there is no specific provision in the Agreement, it is the basic law, i.e, the Income-tax Act, that will govern the taxation of income."

The Calcutta High Court held that the circular reflected the correct legal position inasmuch as the convention or agreement is arrived at by the two Contracting States "in deviation from the general principles of taxation applicable to the Contracting States". Otherwise, the double taxation avoidance agreement will have no

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meaning at all.

In Commissioner of Income Tax v. R.M. Muthaiah the Karnataka High Court was concerned with the DTAT between Government of India and Government of Malaysia. The High Court held that under the terms of agreement, if there was a recognition of the power of taxation with the Malaysian Government, by implication it takes away the corresponding power of the Indian Government. The Agreement was thus held to operate as a bar on the power of the Indian Government to tax and that the bar would operate on Sections 4 and 5 of the Income Tax Act, 1961, and take away the power of the Indian Government to levy tax on the income in respect of certain categories as referred to in certain Articles of the Agreement. The High Court summed up the situation by observing (at p.512-513):

"The effect of an "agreement" entered into by virtue of section 90 of the Act would be : (1) If no tax liability is imposed under this Act, the question of resorting to the agreement would not arise. No provision of the agreement can possibly fasten a tax liability where the liability is not imposed by this Act; (ii) if a tax liability is imposed by this Act, the agreement may be resorted to for negativing or reducing it; (iii) in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of this Act and can be enforced by the appellate authorities and the court."

It also approved of the correctness of the Circular No. 333 dated April 2, 1982 issued by the Central Board of Direct Taxes on the subject.

In Arabian Express Line Ltd. of United Kingdom and Others v. Union of India the Gujarat High Court, interpreting section 90, in the light of circular No.333 dated April 2, 1982 issued by the CBDT, held that the procedure of assessing the income of a NRI because of his occasional activities in establishing business in India would not be applicable in a case where there is a convention between the Government of India and the foreign country as provided under Section 90 of the Income-tax Act, 1961. In case of such an agreement, section 90 would have an overriding effect. Interestingly, in this case a certificate issued by the H.M. Inspector of Taxes certifying that the company was a resident of the United Kingdom for purposes of tax and that it had paid advance corporate tax in the office of the English Revenue Accounts Office, was held to be sufficient to take away the jurisdiction of the Income-tax Officer.

A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. When that happens, the provisions of such an agreement, with respect to cases to which where they apply, would operate even if inconsistent with the provisions of the Income-tax Act. We approve of the reasoning in the decisions which we have noticed. If it was not the intention of the legislature to make a departure from the general principle of chargeability to tax under section 4 and the general principle of ascertainment of total income under section 5 of the Act, then there was no purpose in making those sections "subject to the provisions" of the Act". The very object of grafting the said two sections with the said clause is to enable the Central Government to issue a notification

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under section 90 towards implementation of the terms of the DTAs which would automatically override the provisions of the Income-tax Act in the matter of ascertainment of chargeability to income tax and ascertainment of total income, to the extent of inconsistency with the terms of the DTAC.

The contention of the respondents, which weighed with the High Court viz. that the impugned circular No.789 is inconsistent with the provisions of the Act, is a total non-sequitur. As we have pointed out, Circular No.789 is a circular within the meaning of section 90; therefore, it must have the legal consequences contemplated by sub-section (2) of section 90. In other words, the circular shall prevail even if inconsistent with the provisions of Income-tax Act, 1961 insofar as assessees covered by the provisions of the DTAC are concerned.

Though a number of interconnected and diffused arguments were addressed, broadly the argument of the respondents appears to be as follows: By reason of Article 265 of the Constitution, no tax can be levied or collected except by authority of law. The authority to levy tax or grant exemption therefrom vests absolutely in the Parliament and no other body, howsoever high, can exercise such power. Once Parliament has enacted the Income-tax Act, taxes must be levied and collected in accordance therewith and no person has power to grant any exemption therefrom. The treaty making power under Article 73 is confined only to such matters as would not fall within the province of Article 265. With respect to fiscal treaties, the contention is that they cannot be enforced in contravention of the provisions of the Income-tax Act, unless Parliament has made an enabling law in support. The respondents highlighted the provisions of the OECD models with regard to tax treaties and how tax treaties were enunciated, signed and implemented in America, Britain and other countries. Placing reliance on the observations of Kier and Lawson , it was contended that in England it has been recognised that "there are, however, two limits to its capacity; it cannot legislate and it cannot tax without the concurrence of the Parliament". It is urged that the situation is the same in India; that unless there is a specific exemption granted by the Parliament, it is not open for the Central Government to grant any exemption from the tax payable under the Income-tax Act.

In our view, the contention is wholly misconceived.
Section 90, as we have already noticed (including its precursor under the 1922 Act), was brought on the statute book precisely to enable the executive to negotiate a DTAC and quickly implement it. Even accepting the contention of the respondents that the powers exercised by the Central Government under section 90 are delegated powers of legislation, we are unable to see as to why a delegatee of legislative power in all cases has no power to grant exemption. There are provisions galore in statutes made by Parliament and State legislatures wherein the power of conditional or unconditional exemption from the provisions of the statutes are expressly delegated to the executive. For example, even in fiscal legislation like the Central Excise Act and Sales Tax Act, there are provisions for exemption from the levy of tax. Therefore we are unable to accept the contention that the delegate of a legislative power cannot exercise the power of exemption in a fiscal statute. The niceties of the OECD model of tax treaties or the report of the Joint Parliamentary Committee on the State Market Scam and Matters Relating thereto, on which considerable time was spent by Mr. Jha, who appeared in person, need not detain us for too long, though we shall advert to them later. This Court is not concerned with the manner in which tax treaties are negotiated or enunciated; nor is it concerned with the wisdom of any particular

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treaty. Whether the Indo-Mauritius DTAC ought to have been enunciated in the present form, or in any other particular form, is none of our concern. Whether section 90 ought to have been placed on the statute book, is also not our concern. Section 90, which delegates powers to the Central Government, has not been challenged before us, and, therefore, we must proceed on the footing that the section is constitutionally valid. The challenge being only to the exercise of the power emanating from the section, we are of the view that section 90 enables the Central Government to enter into a DTAC with the foreign Government. When the requisite notification has been issued thereunder, the provisions of sub-section (2) of section 90 spring into operation and an assessee who is covered by the provisions of the DTAC is entitled to seek benefits thereunder, even if the provisions of the DTAC are inconsistent with the provisions of Income-tax Act, 1961.

STARE DECISIS

The learned Attorney General justifiably relied on the observations of this Court in Mishri Lal v. Dhirendra Nath (Dead) by Lrs. and Others in which this Court referred to its earlier decision in Muktul v. Manbhari on the scope of the doctrine of stare decisis with reference to Halsbury's Law of England and Corpus Juris Secundum, pointing out that a decision which has been followed for a long period of time, and has been acted upon by persons in the formation of contracts or in the disposition of their property, or in the general conduct of affairs, or in legal procedure or in other ways, will generally be followed by courts of higher authority other than the court establishing the rule, even though the court before whom the matter arises afterwards might be of a different view. The learned Attorney General contended that the interpretation given to section 90 of the Income-tax Act, a Central Act, by several High Courts without dissent has been uniformally followed; several transactions have been entered into based upon the said exposition of the law; that several tax treaties have been entered into with different foreign Governments based upon this law, hence, the doctrine of stare decisis should apply or else it will result in chaos and open up a Pandora's box of uncertainty.

We think that this submission is sound and needs to be accepted. It is not possible for us to say that the judgments of the different High Courts noticed have been wrongly decided by reason of the arguments presented by the respondents. As observed in Mishrilal even if the High Courts have consistently taken an erroneous view, (though we do not say that the view is erroneous) it would be worthwhile to let the matter rest, since large numbers of parties have modulated their legal relationship based on this settled position of law.

Effect of circular under Section 119

Much of the argument centred around the effect of the circular issued by the CBDT under Section 119 of the Act and its binding nature.

Section 119, strategically placed in Chapter XIII which deals with 'Income-Tax Authorities' is an enabling power of the CBDT, which is recognised as an authority under the Income-tax Act under section 116(a). The CBDT under this section is empowered to issue such orders instructions and directions to other income-tax authorities "as it may deem fit for proper administration of this Act". Such authorities and all other persons employed in the execution of this Act are bound to observe and follow such orders, instructions and directions of the CBDT. The proviso to sub-section (1) of section 119 recognises two exceptions to this power. First, that the CBDT cannot require any

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income-tax authority to make a particular assessment or to dispose of a particular case in a particular manner. Second, is with regard to interference with the discretion of the Commissioner (Appeals) in exercise of his appellate functions. Sub-section(2) of Section 119 provides for the exercise of power in certain special cases and enables the CBDT, if it considers it necessary or expedient so to do for the purpose of proper and efficient management of the work of assessment and collection of revenue, to issue general or special orders in respect of any class of incomes of class of cases , setting forth directions or instructions as to the guidelines, principles or procedures to be followed by other income-tax authorities in the discharge of their work relating to assessment or initiating proceedings for imposition of penalties. The powers of the CBDT are wide enough to enable it to grant relaxation from the provisions of several sections enumerated in clause (a). Such orders may be published in the Official Gazette in the prescribed manner, if the CBDT is of the opinion that it is so necessary. The only bar on the exercise of power is that it is not prejudicial to the assessee. We are not concerned with the provisions in clauses (b) and (c) in the present appeals.

In K.P. Varghese v. Income-Tax Officer, Ernakulam it was pointed out by this Court that not only are the circulars and instructions, issued by the CBDT in exercise of the power under section 119, binding on the authorities administering the tax department, but they are also clearly in the nature of contemporanea expositio furnishing legitimate aid to the construction of the Act.

The Rule of contemporanea expositio is that "administrative construction (i.e. contemporaneous construction placed by administrative or executive officers) generally should be clearly wrong before it is overturned; such a construction commonly referred to as practical construction, although non-controlling, is nevertheless entitled to considerable weight, it is highly persuasive."

The validity of this principle was recognised in Baleshwar Bagarti v. Bhagirathi Dass where the Calcutta High Court stated the rule in the following words :

"It is a well-settled principle of interpretation that courts in construing a statute will give much weight to the interpretation put upon it, at the time of its enactment and since, by those whose duty it has been to construe, execute and apply it."

The statement of this rule has also been quoted with approval by this Court in Deshbandhu Gupta & Company v. Delhi Stock Exchange Association Ltd .

In K.P. Varghese this Court held that the circulars of the CBDT issued in exercise of its power under section 119 are legally binding on the revenue and that this binding character attaches to the circulars "even if they be found not in accordance with the correct interpretation of sub-section (2) and they depart or deviate from such construction."

Navnit Lal C. Javeri v. K.K.Sen and Ellerman Lines Ltd. v. CIT clearly establish the principle that circulars issued by the CBDT under section 119 of the Act are binding on all officers and employees employed in the execution of the Act, even if they deviate from the provisions of the Act.

In UCO Bank v. Commissioner of Incom-Tax , dealing

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with the legal status of such circulars, this Court observed:
"Such instructions may be by way of relaxation of any of the provisions of the sections specified there or otherwise. The Board thus has power, inter alia, to tone down the rigour of the law and ensure a fair enforcement of its provisions, by issuing circulars in exercise of its statutory powers under section 119 of the Income-tax Act which are binding on the authorities in the administration of the Act. Under section 119(2) however, the circulars as contemplated therein cannot be adverse to the assessee. Thus the authority which wields the power for its own advantage under the Act is given the right to forgo the advantage when required to wield it in a manner it considers just by relaxing the rigour of the law or in other permissible manners as laid down in section 119. The power is given for the purpose of just, proper and efficient management of the work of assessment and in public interest. It is a beneficial power given to the Board for proper administration of fiscal law so that undue hardship may not be caused to the assessee and the fiscal laws may be correctly applied. Hard cases which can be properly categorised as belonging to a class, can thus be given the benefit of relaxation of law by issuing circulars binding on the taxing authorities."

In Commissioner of Income-Tax v. Anjum M.H.Ghaswala and Others it was pointed out that the circulars issued by CBDT under Section 119 of the Act have statutory force and would be binding on every income-tax authority although such may not be the case with regard to press releases issue by the CBDT for information of the public.

In Collector of Central Excise Vadodra v. Dhiren Chemical Industries , this Court, interpreting the phrase 'appropriate', observed :
"We need to make it clear that, regardless of the interpretation that we have placed on the said phrase, if there are circulars which have been issued by the Central Board of Excise and Customs which place a different interpretation upon the said phrase, that interpretation will be binding upon the Revenue."

While commenting adversely upon the validity of the impugned circular, the High Court says "that the circular itself does not show that the same has been issued under Section 119 of the Income-tax Act. Only in a case where the circular is issued under Section 119 of the Income-tax Act, the same would be legally binding on the revenue. The circular does not deal with the power of the ITO to consider the question as to whether although apparently a company is incorporated in Mauritius but whether the company is also a resident of India and/or not a resident of Mauritius at all." It is trite law that as long as an authority has power, which is traceable to a source, the mere fact that source of power is not indicated in an instrument does not render the instrument invalid.

Is the impugned circular ultra-vires Section 119 ?

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It was contended successfully before the High Court that the circular is ultra vires the provisions of section 119. Sub-section(1) of section 119 is deliberately worded in general manner so that the CBDT is enabled to issue appropriate orders, instruction or direction to the subordinate authorities "as it may deem fit for the proper administration of the Act". As long as the circular emanates from the CBDT and contains orders, instructions or directions pertaining to proper administration of the Act, it is relatable to the source of power under section 119 irrespective of its nomenclature. Apart from sub-section(1), sub-section(2) of section 119 also enables the CBDT "for the purpose of proper and efficient management of the work of assessment and collection of revenue, to issue appropriate orders, general or special in respect of any class of income or class of cases, setting forth directions or instructions (not being prejudicial to assessees) as to the guidelines, principles or procedures to be followed by other income tax authorities in the work relating to assessment or collection of revenue or the initiation of proceedings for the imposition of penalties". In our view, the High Court was not justified in reading the circular as not complying with the provisions of section 119. The circular falls well within the parameters of the powers exercisable by the CBDT under Section 119 of the Act.

The High Court persuaded itself to hold that the circular is ultra vires the powers of the CBDT on completely erroneous grounds. The impugned circular provides that whenever a certificate of residence is issued by the Mauritius Authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly. It also provides that the test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of Article 13. This, the High Court thought amounts to issuing instructions "de hors the provisions of the Act".

In our view, this thinking of the High Court is erroneous. The only restriction on the power of the CBDT is to prevent it from interfering with the course of assessment of any particular assessee or the discretion of the Commissioner of Income-Tax (Appeals). It would be useful to recall the background against which this circular was issued.

The Income-tax authorities were seeking to examine as to whether the assessees were actually residents of a third country on the basis of alleged control of management therefrom. We have already extracted the relevant provisions of Article 4 which provide that, for the purposes of the agreement, the term ’resident of a contracting State’ means any person who under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of similar nature. The term ’resident of India’ and ’the resident of Mauritius’ are to be construed accordingly. Article 13 of the DTAC lays down detailed rules with regard to taxation of capital gains. As far as capital gains resulting from alienation of shares are concerned, Article 13(4) provides that the gains derived by a ’resident’ of a contracting State shall be taxable only in that State. In the instant case, such capital gains derived by a resident of Mauritius shall be taxable only in Mauritius. Article 4, which we have already referred to, declares that the term resident of Mauritius’ means any person who under the laws of Mauritius is ’liable to taxation’ therein by reason, inter alia, of his residence.

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Clause (2) of Article 4 enumerates detailed rules as to how the residential status of an individual resident in both contracting States has to be determined for the purposes of DTAC. Clause(3) of Article 4 provides that if, after application of the detailed rules provided in Article 4, it is found that a person other than an individual is a resident of both the contracting States, then it shall be deemed to be a resident of the contracting State in which its place of effective management is situated. The DTAC requires the test of 'place of effective management' to be applied only for the purposes of the tie-breaker clause in Article 4(3) which could be applied only when it is found that a person other than an individual is a resident both of India and Mauritius. We see no purpose or justification in the DTAC for application of this test in any other situation.

The High Court has held, and the respondents so contend, that the assessing officer under the Income-tax Act is entitled to lift the corporate veil, but the circular effectively bars the exercise of this quasi-judicial function by reason of a presumption with regard to the certificate issued by the competent authority in Mauritius; conclusiveness of such a certificate of residence granted by the Mauritius tax authorities is neither contemplated under the DTAC, nor under the Income-tax Act a provision as to conclusiveness of a certificate is a matter of legislative action and cannot form the subject matter of a circular issued by a delegate of legislative power.

As early as on March 30, 1994, the CBDT had issued circular no.682 in which it had been emphasised that any resident of Mauritius deriving income from alienation of shares of an Indian company would be liable to capital gains tax only in Mauritius as per Mauritius tax law and would not have any capital gains tax liability in India. This circular was a clear enunciation of the provisions contained in the DTAC, which would have overriding effect over the provisions of sections 4 and 5 of the Income-tax Act,1961 by virtue of section 90(1) of the Act. If, in the teeth of this clarification, the assessing officers chose to ignore the guidelines and spent their time, talent and energy on inconsequtial matters, we think that the CBDT was justified in issuing 'appropriate' directions vide circular no.789, under its powers under section 119, to set things on course by eliminating avoidable wastage of time, talent and energy of the assessing officers discharging the onerous public duty of collection of revenue. The circular no.789 does not in any way crib, cabin or confine the powers of the assessing officer with regard to any particular assessment. It merely formulates broad guidelines to be applied in the matter of assessment of assessees covered by the provisions of the DTAC.

We do not think the circular in any way takes away or curtails the jurisdiction of the assessing officer to assess the income of the assessee before him. In our view, therefore, it is erroneous to say that the impugned circular No.789 dated 13.4.2000 is ultra vires the provisions of section 119 of the Act. In our judgment, the powers conferred upon the CBDT by sub-sections (1) and (2) of Section 119 are wide enough to accommodate such a circular.

Is the DTAC bad for excessive delegation ?

The respondents contend that a tax treaty entered into within the umbrella of section 90 of the Act is essentially delegated legislation; if it involves granting of exemption from tax, it would amount to delegation of legislative powers, which is bad. The legislature must declare the policy of the law and the legal principles

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which are to control any given case and must provide a procedure to execute the law.

The question whether a particular delegated legislation is in excess of the power of the supporting legislation conferred on the delegate, has to be determined with regard not only to specific provisions contained in the relevant statute conferring the power to make rule or regulation, but also the object and purpose of the Act as can be gathered from the various provisions of the enactment. It would be wholly wrong for the Court to substitute its own opinion as to what principle or policy would best serve the objects and purposes of the Act, nor is it open to the Court to sit in judgment of the wisdom, the effectiveness or otherwise of the policy, so as to declare a regulation to be ultra vires merely on the ground that, in the view of the Court, the impugned provision will not help to carry through the object and purposes of the Act. This court reiterated the legal position, well established by a long series of decisions, in Maharashtra State Board of Secondary and Higher Secondary Education and another v. Paritosh Bhupeshkumar Sheth and Others :
"So long as the body entrusted with the task of framing the rules or regulations acts within the scope of the authority conferred on it, in the sense that the rules or regulations made by it have a rational nexus with the object and purpose of the statute, the court should not concern itself with the wisdom or efficaciousness of such rules or regulations. It is exclusively within the province of the legislature and its delegate to determine, as a matter of policy, how the provisions of the statute can best be implemented and what measures, substantive as well as procedural would have to be incorporated in the rules or regulations for the efficacious achievement of the objects and purposes of the Act. It is not for the Court to examine the merits or demerits of such a policy because its scrutiny has to be limited to the question as to whether the impugned regulations fall within the scope of the regulation-making power conferred on the delegate by the statute."

Applying this test, we are unable to hold that the impugned circular amounts to impermissible delegation of legislative power. That the amendment made in section 90 was intended to empower the Government to enter into agreement with foreign Government, if necessary, for relief from or avoidance of double taxation, is also made clear by the Finance Minister in his Budget Speech, 1953-54

Is the Double Taxation Avoidance Convention 'DTAC') illegal and ultra vires the powers of the Central Government u/S 90

Although the High court has not made any finding of this nature, the respondents have strenuously contended before us that the Indo-Mauritius Double Taxation Avoidance Convention, 1983 is itself ultra vires the powers of the Government under Section 90 of the Act. This argument deserves short shrift.

Section 90 empowers the Central Government to enter into agreement with the Government of any other country outside India for the purposes enumerated in clauses (a) to (d) of sub-section (1) . While clause (a) talks of granting relief in respect of income on which income-tax has been paid in India as well as in the foreign country, clause (b) is wider and deals with 'avoidance of double

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taxation of income' under the Act and under the corresponding law in force in the foreign country. We are not concerned with clauses (c) and (d).

There are two hurdles against accepting the arguments presented on behalf of the respondents. Even if we accept the argument of the respondent that the DTAC is delegated legislation, the test of its validity is to be determined, not by its efficacy, but by the fact that it is within the parameters of the legislative provision delegating the power. That the purpose of the DTAC is to effectuate the objectives in clauses (a) and (b) of sub-section (1) of Section 90, is evident upon a reasonable construction of the terms of the DTAC. As long as these two objectives are sought to be effectuated, it is not possible to say that the power vested in the Central Government, under section 90, even if it is delegated power of legislation, has been used for a purpose ultra vires the intendment of the section. The respondents tried to highlight a number of unintended deleterious consequences which, according to them, have arisen as a result of implementation of the DTAC. Even if they be true, it would not enable this Court to strike down the delegated legislation as ultra vires. The validity and the vires of the legislation, primary, or delegated, has to be tested on the anvil of the law making power. If an authority lacks the power, then the legislation is bad. On the contrary, if the authority is clothed with the requisite power, then irrespective of whether the legislation fails in its object or not, the vires of the legislation is not liable to be questioned. We are, therefore, unable to accept the contention of the respondents that the DTAC is ultra vires the powers of the Central Government under Section 90 on account of its susceptibility to 'treaty shopping' on behalf of the residents of third countries.

The High Court seems to have heavily relied on an assessment order made by the assessing officer in the case of Cox and Kings Ltd. drawing inspiration therefrom. We are afraid that it was impermissible for the High Court to do so. An assessment made in the case of a particular assessee is liable to be challenged by the Revenue or by the assessee by the procedure available under the Act. In a Public Interest Litigation it would be most unfair to comment on the correctness of the assessment order made in the case of a particular assessee, especially when the assessee is not a party before the High Court. Any observation made by the Court would result in prejudice to one or the other party to the litigation. For this reason, we refrain from making any observations about the correctness or otherwise of the assessment order made in Cox and Kings Ltd. Needless to say, we decline to draw inspiration therefrom, for our inspiration is drawn from principles of law as gathered from statutes and precedents.

What is "liable to taxation"
Fiscal Residence

The concept of 'fiscal residence' of a company assumes importance in the application and interpretation of double taxation avoidance treaties.
In Cahiers De Droit Fiscal International it is said that under the OECD and UNO Model Convention, 'fiscal residence' is a place where a person amongst others a corporation is subjected to unlimited fiscal liability and subjected to taxation for the worldwide profit of the resident company. At para 2.2 it is pointed out :

"The UNO Model Convention takes these two different concepts into account. It has not

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embodied the second sentence of article 4, paragraph 1 of the OECD Model Convention, which provides that the term 'resident' does not include any person who is liable to tax in that State in respect only of income from sources in that State. In fact, if one adhered to a strict interpretation of this text, there would be no resident in the meaning of the convention in those States that apply the principle of territoriality."

Again in paragraph 3.5 it is said :

"The existence of a company from a company law standpoint is usually determined under the law of the State of incorporation or of the country where the real seat is located. On the other hand, the tax status of a corporation is determined under the law of each of the countries where it carries on business, be it as resident or non-resident."

In paragraph 4.1 it is observed that the principle of universality of taxation i.e. the principle of worldwide taxation, has been adopted by a majority of States. One has to consider the worldwide income of a company to determine its taxable profit. In this system it is crucial to define the fiscal residence of a company very accurately. The State of residence is the one entitled to levy tax on the corporation's worldwide profit. The company is subject to unlimited fiscal liability in that State. In the case of a company, however, several factors enter the picture and render the decision difficult. First, the company is necessarily incorporated and usually registered under the tax law of a State that grants it corporate status. A corporation has administrative activities, directors and managers who reside, meet and take decisions in one or several places. It has activities and carries on business. Finally, it has shareholders who control it. Hence, it is opined :
"When all these elements coexist in the same country, no complications arise. As soon as they are dissociated and "scattered" in different States, each country may want to subject the company to taxation on the basis of an element to which it gives preference; incorporation procedure, management functions, running of the business, shareholders' controlling power. Depending on the criterion adopted, fiscal residence will abide in one or the other country.

All the European countries concerned, except France, levy tax on the worldwide profit at the place of residence of the company considered.

South Korea, India and Japan in Asia, Australia and New Zealand in Oceania follow this principle."

In paragraph 4.2.1 it is pointed out that the Anglo-Saxon concept of a company's 'incorporation test', which is applied in the United States, has not been adopted by other countries like Australia, Canada, Denmark, New Zealand and India and instead the criterion of incorporation amongst other tests has been adopted by them.

The judgment in Ingemar Johansson et al v. United State of

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America , on which the respondent place reliance, is easily distinguishable. In this case the appellant, Johansson, was a citizen of Switzerland and a heavyweight boxing champion by profession. He had earned some money by boxing in the United States for which he was called upon to pay tax. Johansson floated a company in Switzerland of which he became an employee and contended that all professional fee paid for his boxing bouts were received by his employer company in Switzerland for which he was remunerated as an employee of the said company. He sought to take advantage of the DTAT between USA and Switzerland which provided "an individual resident of Switzerland shall be exempt from United States Tax upon compensation for labour personal services performed in the United States.... if he is temporarily present in the United States for a period or periods not exceeding a total of 183 during the taxable year..." There was no doubt that the appellant was not present in the United States for more than 183 days and that he had floated the Swiss company motivated with the desire to minimise his tax burden. As conclusive proof of residence he relied upon a determination by the Swiss Tax Authority that he had become a resident of Switzerland on a particular date. The United States Court of Appeal rejected the claim of the appellant pointing out that the term "resident" had not been defined in the US-Swiss treaty, but under article II(2) each country was authorised to apply its own definition to terms not expressly defined 'unless the context otherwise requires'. The Court, therefore, held that the determination of the appellant's residence statues by the Swiss tax authority, according to Swiss law, was not conclusive and that the U.S. tax authorities were entitled to decide it in accordance with the US laws under the treaty. Hence, it was held that Johansson was not a resident of Switzerland during the period in question and that the tax exemption in the treaty was not available to him.

In our view, this judgment, though relied upon very heavily by the respondents, is of no avail. The Indo-Mauritius DTAC, Article 3, clearly defines the term 'residence' in a 'Contracting State'. Interestingly, even in this judgment, the Court observed : "Of course, the fact that Johansson was motivated in his actions by the desire to minimize his tax burden can in no way be taken to deprive him of an exemption to which an applicable treaty entitles him", which will have some relevance to the contention of the respondents with regard to the motivation to avoid tax.

The respondents contend that the FIIs incorporated and registered under the provisions of the law in Mauritius are carrying on no business there; they are, in fact, prevented from earning any income there; they are not liable to income tax on capital gains under the Mauritius Income-tax Act. They are liable to pay income-tax under Indian Income-tax Act, 1961, since they do not pay any income-tax on capital gains in Mauritius, hence, they are not entitled to the benefit of avoidance of double taxation under the DTAC.

Some of the assumptions underlying this contention, which prevailed with the High Court, need greater critical appraisal.

Article 13(4) of the DTAC provides that gains derived by a resident of a Contracting State from alienation of any property, other than those specified in the paragraphs 1, 2 and 3 of the Article, shall be taxable only in that State. Since most of the arguments centred around capital gains made on transactions in shares on the stock exchange in India, we may leave out of consideration capital gains on the type of properties contemplated in paras 1, 2 and 3 of Article 13 of the DTAC. The residuary clause in para 4 of Article 13 is relevant. It provides that capital gains made on sale of shares shall be taxable only in the State of which the person is a 'resident' taking us back to the meaning of the term 'resident' of a contracting State. According to Article 4, this

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expression means any person who under the laws of that State is "liable to taxation" therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. The terms 'resident of India' and 'resident of Mauritius' are required to be construed accordingly. This takes us to the test to determine when a company is 'liable to taxation' in Mauritius.

Mauritian Income Tax Act, 1995

Section 4 of the Income Tax Act, 1995 (Mauritian Income-tax Act) provides that, subject to the provisions of the Act, income-tax shall be paid to the Commissioner of Income-tax by every person on all income other than exempt income derived by him during the preceding year and be calculated on the chargeable income of the person at the appropriate rate specified in the First Schedule.
Section 5 defines as to when income is deemed to be derived.

Section 7 provides that the income specified in the Second Schedule shall be exempt from income-tax.
Part IV of the Mauritian Income Tax Act deals with Corporate Taxation.

Section 44 of the Act provides that every company shall be liable to income tax on its 'chargeable income' at the rate specified in Part II, Part III or Part IV of the First Schedule, as the case may be.

Section 51 defines the 'gross income' of a company as inclusive of income referred to in section 10(1)(b) (income derived from business), 10(1)(c) (any income from rent, premium or other income derived from property), 10(1)(d) (any dividend, interest, charges, annuity or pension other than a pension referred to in paragraph a(ii)) and 10(1)(e) (any other income derived from any other source).

Section 73 (b) provides that for the purposes of the Act the expression 'resident', when applied to a 'company', means a company which is incorporated in Mauritius or has its central management and control in Mauritius.

Part II of the First Schedule prescribes the rate of tax on chargeable income at 15% in the case of Tax Incentive companies and at other rates for other types of companies. Part V of the First schedule enumerates the list of tax incentive companies and item 16 is : "a corporation certified to be engaged in international business activity by the Mauritius Offshore Business Activities Authority established under the Mauritius Offshore Business Activities Act, 1992". The second Schedule to the Mauritius Income-tax Act in Part IV enumerates miscellaneous income exempt from income-tax. Item 1 reads "gains or profits derived from the sale of units or of securities quoted on the Official List or on such Stock Exchanges or other exchanges and capital markets as may be approved by the Minister".

A perusal of the aforesaid provisions of the Income Tax Act in Mauritius does not lead to the result that tax incentive companies are not liable to taxation, although they have been granted exemption from income-tax in respect of a specified head of income, namely, gains from transactions in shares and securities. The respondents contend that the FIIs are not "liable to taxation" in Mauritius; hence they are not 'residents' of Mauritius within the meaning of Article 4 of the DTAC. Consequently, it is open to the assessing officers under the Indian Income-tax Act, 1961 to determine where the taxable entities are really resident by investigating the centre of their management and thereafter to apply the provisions of Income-tax Act, 1961 to the global income earned by them by reason of sections 4 and 5 of the Income-tax

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Act, 1961.

It is urged by the learned Attorney General and Shri Salve for the appellants that the phrase 'liable to taxation' is not the same as 'pays tax'. The test of liability for taxation is not to be determined on the basis of an exemption granted in respect of any particular source of income, but by taking into consideration the totality of the provisions of the income-tax law that prevails in either of the Contracting States. Merely because, at a given time, there may be an exemption from income-tax in respect of any particular head of income, it cannot be contended that the taxable entity is not liable to taxation. They urge that upon a proper construction of the provisions of Mauritian Income Tax Act it is clear that the FIIs incorporated under Mauritius laws are liable to taxation; therefore, they are 'residents' in Mauritius within the meaning of the DTAC.

For the appellants reliance is placed on the judgment of this Court in Wallace Flour Mills Contracting State. Ltd. v. Collector of Central Excise, Bombay Division II , a case under the Central Excise Act. This Court held that though the taxable event for levy of excise duty is the manufacture or production, the realisation of the duty my be postponed for administrative convenience to the date of removal of the goods from the factory. It was held that excisable goods do not become non-excisable merely because of an exemption given under a notification. The exemption merely prevents the excise authorities from collecting tax when the exemption is in operation.

In Kasinka Trading and Another v. Union of India and Another this principle was reiterated in connection with an exemption under the Customs Act. This Court observed :"The exemption notification issued under section 25 of the Act had the effect of suspending the collection of customs duty. It does not make items which are subject to levy of customs duty etc. as items not leviable to such duty. It only suspends the levy and collection of customs duty, wholly or partially, and subject to such conditions as may be laid down in the notification by the Government in 'public interest'. Such an exemption by its very nature is susceptible of being revoked or modified or subjected to other conditions."

We are inclined to agree with the submission of the appellants that, merely because exemption has been granted in respect of taxability of a particular source of income, it cannot be postulated that the entity is not 'liable to tax' as contended by the respondents.

Effect of MOBA, 1992

The respondents, shifted ground to contend that the fact that a company incorporated in Mauritius is liable to taxation under the Income Tax Act there may be true only in respect of certain class of companies incorporated there. However, with respect to companies which are incorporated within the meaning of the Mauritius Offshore Business Activities Act, 1992 (hereinafter referred to as "MOBA"), this would be wholly incorrect.

MOBA was enacted "to provide for the establishment and management of the MOBA Authority to regulate offshore business activities from within Mauritius and for the issue of offshore certificates, and to provide for other ancillary or incidental matters", as its preamble suggests. 'Offshore business activity' is defined as the business or other activity referred to in section 33 and includes activity conducted by an international company.

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'Offshore company' is defined as a corporation in relation to which there is a valid certificate and which carries on offshore business activity.
In part II, MOBA establishes an Offshore Business Activity Authority entrusted, inter alia, with the duty of overseeing offshore business activities and also issuing permits, licences or any other certificate as may be required, and other authorisation which may be required by an offshore company through which they may communicate with any of the public sector companies.

Section 16 of MOBA prescribes the procedure for issuing of a certificate. Section 15 requires maintenance of confidentiality and non-disclosure of information contained in applications and documents filed with it except where such information is bona fide required for the purpose of any enquiry or trial into or relating to the trafficking of narcotics and dangerous drugs, arms, trafficking or money laundering under the Economic Crime and Anti Money Laundering Act, 2000.
Part II of MOBA contains the statutory provisions applicable to offshore companies. Section 26 provides that an offshore company shall not hold immovable property in Mauritius and shall not hold any share or any interest in any company incorporated under the Companies Act, 1984, other than in a foreign company or in another offshore company or in an offshore trust or an international company. An offshore company shall not hold any account in a domestic bank in Mauritian Rupees, except for the purpose of its day to day transactions arising from its ordinary operations in Mauritius.
Sections 26 and 27 of MOBA are important and read as under:
"26. Property of an offshore company

(1) Subject to sub-section(2), an offshore company shall not hold -

(a) immovable property in Mauritius ;

(b) any share, or any interest in any company incorporated under the Companies Act, 1984 other than in a foreign company or in another offshore company or in an offshore trust or an international company ;

(c) any account in a domestic bank in Mauritian Rupee

(2) An offshore company may -

(a) open and maintain with a domestic bank an account in Mauritian rupees for the purpose of its day to day transactions arising from its ordinary operations in Mauritius ;

(b) open and maintain with a domestic bank an account in foreign currencies with the approval of the Bank of Mauritius ;

(c) where authorised by the terms of its certificate, or where otherwise permitted under any other enactment, lease, hold, acquire or dispose of an immovable property or any interest in

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immovable property situated in Mauritius ;

(d) invest in any securities listed in the stock Exchange established under the Stock Exchange Act 1988 and in other debentures.

27. Dealings with residents

Notwithstanding any other enactment, the Minister, on the recommendation of the Authority may authorise any offshore company engaged in any offshore business activities to deal or transact with residents on such terms and conditions as it thinks fit."

On the basis of these provisions, it is urged by the respondents that any company which is registered as an offshore company under MOBA can hardly carry out any business activity in Mauritius, since it cannot hold any immovable property or any shares or interest in any company registered in Mauritius other than a foreign company or another offshore company and cannot open an account in a domestic bank in Mauritius. The respondents urge that such a company cannot transact any business whatsoever within Mauritius as the purpose of such a company would be to carry out offshore business activities and nothing more. The respondents contend that when the possibility of such a company earning income within Mauritius is almost nil, there is hardly any possibility of its paying tax in Mauritius, whatever be the provisions of the Mauritian Income-Tax Act.

In our view, the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the DTAC, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the DTAC would not have used the words 'liable to taxation', but would have used some appropriate words like 'pays tax'. On the language of the DTAC, it is not possible to accept the contention of the respondents that offshore companies incorporated and registered under MOBA are not 'liable to taxation' under the Mauritius Income-tax Act; nor is it possible to accept the contention that such companies would not be 'resident' in Mauritius within the meaning of Article 3 read with Article 4 of the DTAC.

There is a further reason in support of our view. The expression 'liable to taxation' has been adopted from the Organisation for Economic Co-operation and Development Council (OECD) Model Convention 1977. The OECD commentary on article 4, defining 'resident', says: "Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, consequently, is fully liable to tax in that State". The expression used is 'liable to tax therein', by reasons of various factors. This definition has been carried over even in Article 4 dealing with 'resident' in the OECD Model Convention 1992.

In A Manual on the OECD Model Tax Convention on Income and On Capital, at paragraph 4B.05, while commenting on Article 4 of the OECD Double Tax Convention, Philip Baker

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points out that the phrase 'liable to tax' used in the first sentence of Article 4.1 of the Model Convention has raised a number of issues, and observes:

"It seems clear that a person does not have to be actually paying tax to be "liable to tax" - otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the convention. It also seems clear that a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, if the exemption were repealed, or the person no longer qualified for the exemption, the person would be liable to comprehensive taxation."

Interestingly, Baker refers to the decision of the Indian Authority for Advance Ruling in Mohsinally Alimohammed Rafik. An assessee, who resided in Dubai and claimed the benefits of UAE-India Convention of April 29, 1992, even though there was no personal income-tax in Dubai to which he might be liable. The Authority concluded that he was entitled to the benefits of the convention. The Authority subsequently reversed this position in the case of Cyril Eugene Pereira where a contrary view was taken.

The respondents placed great reliance on the decision by the Authority for Advance Rulings constituted under section 245-O of the Income-Tax Act, 1961 in Cyril Eugene Pereira's case . Section 245S of the Act provides that the Advance Ruling pronounced by the Authority under section 245R shall be binding only :

"(a) on the applicant who had sought it;
(b) in respect of the transaction in relation to which the ruling had been sought; and

(c) on the Commissioner, and the income-tax authorities subordinate to him, in respect of the applicant and the said transaction."

It is therefore obvious that, apart from whatever its persuasive value, it would be of no help to us. Having perused the order of the Advance Rulings Authority, we regret that we are not persuaded.

There is substance in the contention of Mr. Salve learned counsel for one of the appellants, that the expression 'resident' is employed in the DTAC as a term of limitation, for otherwise a person who may not be 'liable to tax' in a Contracting State by reason of domicile, residence, place of management or any other criterion of a similar nature may also claim the benefit of the DTAC. Since the purpose of the DTAC is to eliminate double taxation, the treaty takes into account only persons who are 'liable to taxation' in the Contracting States. Consequently, the benefits thereunder are not available to persons who are not liable to taxation and the words 'liable to taxation' are intended to act as words of limitation.

In John N. Gladden v. Her Majesty the Queen the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed :

"Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal

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interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned."

Gladden was a case where an American citizen resident in U.S.A. owned shares in two privately controlled Canadian companies. Upon his death, the question arose as to the capital gains which would arise as a result of the deemed disposition of the said shares. The Canadian Revenue took the position that there was a deemed disposition of the shares on the death of the tax payer and capital gains tax was chargeable on account of the deemed disposition. This view of the Revenue was upheld in appeal by the Tax Court of Canada. Upon further appeal to the Federal Court it was held that capital gains were exempt from tax under the Canada-U.S.A. Tax Treaty as Canada had no capital gains tax when it entered the treaty and it could not unilaterally amend its legislation. The argument which prevailed with the trial court in this case was similar to the one which prevailed with the High Court in the matter before us. Interpreting the relevant Article of the Double Taxation Avoidance Treaty the trial court held : "The parties could not have negotiated to avoid double taxation on a tax which did not exist in Canada". The Federal Court emphasised that in interpreting and applying treaties the Courts should be prepared to extend "a liberal and extended construction" to avoid an anomaly which a contrary construction would lead to. The Court recognized that "we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms".

Interpreting the Article of the Treaty against avoidance of double taxation, the Federal Court said (at p.5): "The non-resident can benefit from the exemption regardless of whether or not he is taxable on that capital gain in his own country. If Canada or the U.S. were to abolish capital gains completely, while the other country did not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country."

The appellants rely on this judgment to contend that, irrespective of the exemption from income-tax on capital gains upon alienation of shares under the Mauritius Income-tax Act, the benefits of the DTAC would apply.
The appellants contend that, acceptance of the respondents' submission that double taxation avoidance is not permissible unless tax is paid in both countries is contrary to the intendment of section 90. It is urged that clause (b) of sub-section(1) of Section 90 applies to a situation to grant relief where income tax has been paid in both countries, but clause (b) deals with a situation of avoidance of double taxation of income. Inasmuch as Parliament has distinguished between the two situations, it is not open to a Court of law to interpret clause (b) of section 90 sub-section(1) as if it were the same as the situation contemplated under clause (a).

According to Klaus Vogel "Double Taxation Convention establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax-claims are expected, or at least theoretically possible. In other words, the Contracting States mutually bind themselves not to levy

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taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other contracting States either entirely or in part. Contracting States are said to 'waive' tax claims or more illustratively to divide 'tax sources', the 'taxable objects', amongst themselves." Double taxation avoidance treaties were in vogue even from the time of the League of Nations. The experts appointed in the early 1920s by the League of Nations describe this method of classification of items and their assignments to the Contracting States. While the English lawyers called it 'classification and assignment rules', the German jurists called it 'the distributive rule' (Verteilungsnorm). To the extent that an exemption is agreed to, its effect is in principle independent of both whether the other contracting State imposes a tax in the situation to which the exemption applies, and of whether that State actually levies the tax. Commenting particularly on German Double Taxation Convention with the United States, Vogel comments: "Thus, it is said that the treaty prevents not only 'current', but also merely 'potential' double taxation". Further, according to Vogel, "only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one contracting State dependent upon whether the income or capital is taxable in the other contracting state, or upon whether it is actually taxed there."

It is, therefore, not possible for us to accept the contentions so strenuously urged on behalf of the respondents that avoidance of double taxation can arise only when tax is actually paid in one of the Contracting States.

The decision of Federal Court of Australia in Commissioner of Taxation v. Lamesa Holdings is illuminating. The issue before the Federal Court was whether a Netherlands company was liable to income-tax under the Australian Income Tax Act on profits from the sale of shares in an Australian company and whether such profits fell within Article 13 (alienation of property) of the Netherlands-Australia Double Taxation Agreement, so as to be excluded from Article 7 (business profits) of that Agreement. One Leonard Green, a principal of Leonard Green and Associates a limited partnership established in the United States, became aware of a potential investment opportunity in Australia. Arimco Resources and Mining Company NL ('Armico'), a company listed on the Australian Stock Exchange, which had a subsidiary called Armico Mining Pty. Limited engaged in gold mining activities, was the subject of a hostile takeover bid, at a price which Green was advised was less than the real value of the Armico. With this knowledge Green decided to mount a takeover offer for the subsidiary company. Then followed a series of steps of formation of a number of companies with interlocking share holdings where each company owned 1005 shares of a different subsidiary company. Lamesa Holdings was one such intermediary company of which 100% shares were held by Green Equity Investments Ltd. The share transactions brought about a profit to Lamesa Holdings which would be assessable to tax under the Australian Income Tax Act. Lamesa, however, relied on the provisions of the Article 13(2) of the Double Taxable Avoidance Convention ('DTAC') between Netherlands and Australia and claimed that the income was not taxable in Australia by reason thereof. This income was wholly exempt from tax in Netherlands by reason of the Income Tax Law applicable therein. The Federal Court found that under Article 13(2) (a) (ii) of the DTAC shares in a company were treated as personalty, that since the place of incorporation of a company or the place of situs of a share may be the subject of choice, the place of incorporation or the register upon which shares were registered would not form a particularly close connection with shares to ground the jurisdiction to tax share profits. It was held:

"It happens to be the case, because of unilateral relief granted by the law of the

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Netherlands, that no tax will be payable in the Netherlands. That of itself can not affect the interpretation of the Agreement. If the relevant mining property had happened to be in the Netherlands so that the issue was between taxation there on the one hand and taxation in Australia on the other, the situation would have been one where tax would clearly have been payable on the alienation of the shares in Australia without the benefit of any exemption. Yet the Agreement must operate uniformly, whether the realty is in the Netherlands or in Australia."

In this view of the matter, it was held that there was no tax payable in Australia.

Chong v. Commissioner of Taxation holds similarly. Australia and Malaysia have an agreement to avoid double taxation. An Australian resident was paid pension by Malaysian Government for services rendered to Malaysian Government while he was in service there. This pension was taxed in Malaysia and the issue was whether the right to tax Government pensions under the Agreement could be exercised by the Australian Government and the effect of the domestic law on the agreement. Article 18 of the double taxation avoidance agreement provided that pension paid to a resident of a contracting State shall be taxable only in that State. Upon a proper construction of Article 18(2) of the Treaty it was held that pension paid by Malaysia is taxable in Australia inasmuch as the said Article did not provide that Malaysia alone was to have the power to tax Government pension, nor did it restrict Australia from doing so. Rather it provided for the Contracting State paying the pension to have the power to tax the pension if it so desired and did not limit or restrict the taxing power of the other Contracting State in that respect. The Federal Court pointed out "Whether one uses the language of allocation of power or the language of limitation of power, the result is the same; there is designated or agreed who shall have the right under the agreement to impose taxation in the particular area".

The Estate of Michel Hausmann v. Her Majesty The Queen is another Canadian judgment which throws light on the principle that the benefits of a double taxation agreement would be available even if the other contracting State in which a particular head of income is to be taxed, chooses not to impose tax on the same.

The central question in this case was whether the pension received by Mr.Hausmann from the pension office of the Belgium Government was taxable in Canada. The facts indicated that there was no tax withheld at source in Belgium. The argument of the Canadian Tax Authority was that if Belgium was not going to tax the pension, Canada should. Otherwise, the unthinkable might occur and the amount might not be taxed by anyone. This would be anathema. The facts indicated that the payment received by Mr. Hausmann fell below the prescribed threshold and therefore was not taxed in Belgium. The Canadian Court rejected the argument that if Belgium did not tax the payment, it must be taxed by the Canada as plainly wrong by relying on the terms of the treaty. On the basis of the material available, the Federal Court came to the inference that in negotiating the Belgium treaty both Canada and Belgium unquestionably regarded pensions paid under their social security legislation, such as the CPP or the corresponding Belgian statutory scheme, to be taxable only in the country from which they emanated and not the country of residence of the recipient.

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Hence, it was held that the pension payments received by Mr. Hausmann from the office of Belgium were social security pension and such allowances could be taxable only in Belgium. The fact that Belgium did not choose to tax them was held to be totally irrelevant.

Mr. Salve contended that a profit made by sale of shares may not invariably amount to capital gains, as for example if the shares were part of the trading assets of the company. If such be the case, the gains may amount to trading income of such a company. He also relied on the observations of this Court in Commissioner of Income Tax Nagpur v. Sutlej Cotton Mills Supply Agency Limited . It is not necessary for us to go into this question as it would depend upon as to whether the shares are held by a company as an investment or as a trading asset. The possibility urged by the learned counsel certainly exists and cannot be ruled out without examination of facts.

Treaty Shopping - Is it illegal ?

The respondents vehemently urge that the offshore companies have been incorporated under the laws of Mauritius only as shell companies, which carry on no business therein, and are incorporated only with the motive of taking undue advantage of the DTAC between India and Mauritius. They also urged that 'treaty shopping' is both unethical and illegal and amounts to a fraud on the treaty and that this Court must be astute to interdict all attempts at treaty shopping.

'Treaty shopping' is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States. According to Lord McNair, "provided that any necessary implementation by municipal law has been carried out, there is nothing to prevent the nationals of "third States", in the absence of any expressed or implied provision to the contrary, from claiming the right or becoming subject to the obligation created by a treaty" . Reliance is also placed on the following observations of Lord McNair :

"that any necessary implementation by municipal law has been carried out, there is nothing to prevent the nationals of 'third States', in the absence of any express or implied provision to the contrary, from claiming the rights, or becoming subject to the obligations, created by a treaty; for instance, if an Anglo-American Convention provided that professors on the staff of the universities of each country were exempt from taxation in respect of fees earned for lecturing in the other country, and any necessary changes in the tax laws were made, that privilege could be claimed by, or on behalf of, professors of those universities who were the nationals of 'third States'."

It is urged by the learned counsel for the appellants, and rightly in our view, that if it was intended that a national of a third State should be precluded from the benefits of the DTAC, then a suitable term of limitation to that effect should have been incorporated therein. As a contrast, our attention was drawn to the Article 24 of the Indo-US Treaty on Avoidance of Double Taxation which specifically provides the limitations subject to which the benefits under the Treaty can be availed of. One of the limitations is that more than 50% of the beneficial interest, or in

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the case of a company more than 50% of the number of shares of each class of the company, be owned directly or indirectly by one or more individual residents of one of the contracting States. Article 24 of the Indo-U.S. DTAC is in marked contrast with the Indo-Mauritius DTAC. The appellants rightly contend that in the absence of a limitation clause, such as the one contained in Article 24 of the Indo-U.S. Treaty, there are no disabling or disentitling conditions under the Indo-Mauritius Treaty prohibiting the resident of a third nation from deriving benefits thereunder. They also urge that motives with which the residents have been incorporated in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction. They urge that there is nothing like equity in a fiscal statute. Either the statute applies proprio vigore or it does not. There is no question of applying a fiscal statute by intendment, if the expressed words do not apply. In our view, this contention of the appellants has merit and deserves acceptance. We shall have occasion to examine the argument based on motive a little later.

The decision of the Chancery Division in Re F.G. Films Ltd. was pressed into service as an example of the mask of corporate entity being lifted and account be taken of what lies behind in order to prevent 'fraud'. This decision only emphasises the doctrine of piercing the veil of incorporation. There is no doubt that, where necessary, the Courts are empowered to lift the veil of incorporation while applying the domestic law. In the situation where the terms of the DTAC have been made applicable by reason of section 90 of the Income-Tax Act, 1961, even if they derogate from the provisions of the Income-tax Act, it is not possible to say that this principle of lifting the veil of incorporation should be applied by the court. As we have already emphasised, 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. In our view, therefore, the principle of piercing the veil of incorporation can hardly apply to a situation as the one before us.

The respondents banked on certain observations made in Oppenheim's International Law . All that is stated therein is a reiteration of the general rule in municipal law that contractual obligations bind the parties to their contracts and not a third party to the contract. In international law also, it has been pointed out that the Vienna Convention on the Laws of Treaties ,1969 reaffirms the general rule that a treaty does not create either obligations or rights for a third party state without its consent, based on the general principle pacta tertiis nec nocent nec prosunt. It is true that an international treaty between States A & B is neither intended to confer benefits nor impose obligations on the residents of State C, but, here we are not concerned with this question at all. The question posed for our consideration is: If the residents of State C qualify for a benefit under the treaty, can they be denied the benefit on some theoretical ground that 'treaty shopping' is unethical and illegal ? We find no support for this proposition in the passage cited from Oppenheim.

The respondents then relied on observations of Philip Baker regarding a seminar at the IFI Barcelona in 1991, wherein a paper was presented on "Limitation of treaty benefits for companies" (treaty shopping). He points out that the Committee on Fiscal Affairs of the OECD in its report styled as "Conduit Companies Report 1987" recognised that a conduit company would generally be able to claim treaty benefits.

There is elaborate discussion in Baker's treatise on the anti abuse provisions in the OECD model and the approach of different

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countries to the issue of 'treaty shopping'. True that several countries like the USA, Germany, Netherlands, Switzerland and United Kingdom have taken suitable steps, either by way of incorporation of appropriate provisions in the international conventions as to double taxation avoidance, or by domestic legislation, to ensure that the benefits of a treaty/convention are not available to residents of a third State. Doubtless, the treatise by Philip Baker is an excellent guide as to how a state should modulate its laws or incorporate suitable terms in tax conventions to which it is party so that the possibility of a resident of a third State deriving benefits thereunder is totally eliminated. That may be an academic approach to the problem to say how the law should be. The maxim "Judicis est jus dicere, non dare" pithily expounds the duty of the Court. It is to decide what the law is, and apply it; not to make it.

Report of the working group on non-resident taxation

The respondents contend that anti-abuse provisions need not be incorporated in the treaty since it is assumed that the treaty would only be used for the benefit of the parties. They also strongly rely on the 'Report of the working group on Non-Resident Taxation' dated 3rd January, 2003. In Chapter 3, para 3.2 of the report it is stated:

"3.2 Entitlement to avail DTAA benefit: Presently a person is entitled to claim application of DTAA if he is 'liable to tax' in the other Contracting State. The scope of liability to tax is not defined. The term "liable to tax" should be defined to say that there should be tax laws in force in the other State, which provides for taxation of such person, irrespective that such tax fully or partly exempts such persons from charge of tax on any income in any manner."

In para 3.3.1, after noticing the growing practice amongst certain entities, who are not residents of either of the two Contracting States, to try and avail of the beneficial provisions of the DTAAs and indulge in what is popularly known as 'treaty shopping', the report says :

"3.3.1 ....there is a need to incorporate suitable provisions in the chapter on interpretation of DTAAs, to deal with treaty shopping, conduit companies and thin capitalization. These may be based on UN/OECD model or other best global practices."

In para 3.3.2, the working group recommended introduction of anti-abuse provisions in the domestic law. Finally, in paragraph 3.3.3 it is stated "The Working Group recommends that in future negotiations, provisions relating to anti-abuse/limitation of benefit may be incorporated in the DTAAs also."

We are afraid that the weighty recommendations of the Working Group on Non-Resident Taxation are again about what the law ought to be, and a pointer to the Parliament and the Executive for incorporating suitable limitation provisions in the

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treaty itself or by domestic legislation. This per se does not render an attempt by resident of a third party to take advantage of the existing provisions of the DTAC illegal.

J.P.C. Report

Strong reliance is placed by the respondents on the report of the Joint Parliamentary Committee (hereinafter referred to as "JPC") on the Stock Market Scam and Matters Relating thereto which was presented in the Lok Sabha and Rajya Sabha on December 19, 2002.
While considering the causes which led to the Stock Market scam, the JPC had occasion to consider the working of the Indo-Mauritius DTAC. It noticed that area-wise foreign direct investment inflow from Mauritius increased from 37.5 million Rupees in 1993 to 61672.8 million Rupees in the year 2001. The CBDT had approached the Indian High Commissioner at Mauritius to take up the matter with the Mauritian authorities to ensure that benefit of the bilateral tax treaty were not allowed to be misused, by suitable amendment in Article 13 of the agreement. The Mauritian authorities, however, were of the view that, though the beneficiaries of such capital funds domiciled in Mauritius may be residing in third countries, these funds had been invested in the Indian stock market in accordance with SEBI norms and regulations and that the Finance Minister of India had himself encouraged such FIIs as a channel for promoting capital flow to India in a meeting between himself and the Finance Minister of Mauritius. The Ministry of finance was willing to have regular joint monitoring of the situation to avoid possible misuse of the tax treaty by unscrupulous elements. It was pointed out by the Mauritian authorities that DTAC between the two countries "had played a positive role in covering the higher cost of investing in what was then assessed as 'high risk security' and being decisive in making possible public offerings in U.S.A. and Europe of funds investing in India". In the absence of such a facility, as afforded by the Indo-Mauritius DTAC, the cost of raising such investment would have been capital prohibitive. The JPC report points out that the negotiations between the Government of India and Government of Mauritius resulted in a situation in which the Mauritius Government felt that any change in the provisions of the DTAC would adversely affect the perception of potential investors and would prejudicially affect their financial interests.
The issue still appears to be the subject matter of negotiations between the two Governments, though no final decision has been taken thereupon. The JPC took notice of the facts that MOBA has since been repealed by Mauritius and Financial Services Development Act has been promulgated with effect from 1.12.2001, which has to some extent removed the drawback of MOBA, and led to greater transparency and facility for obtaining information under the DTAC, which was hitherto not available.

Taking notice of the facts, and the reluctance of the Government of Mauritius in the matter to renegotiate the terms of treaty, the Committee recommended as under (vide para 12.205):
"The Committee find that though the exact amount of revenue loss due to the 'residency clause' of the treaty cannot be quantified, but taking into account the huge inflows/outflows, it could be assumed to be substantial. They therefore recommend that Companies investing in Indian through Mauritius, should be required to file details of ownership with RBI and declare that all the Directors and effective management is in

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Mauritius. The Committee suggest that all the contentious issues should be resolved by the Government with the Government of Mauritius urgently through dialogue."

In our view, the recommendations of the Working Group of the JPC are intended for Parliament to take appropriate action. The JPC might have noticed certain consequences, intended or unintended, flowing from the DTAC and has made appropriate recommendations. Based on them, it is not possible for us to say that the DTAC or the impugned circular are contrary to law, nor would it be possible to interfere with either of them on the basis of the report of the JPC.

Interpretation of Treaties

The principles adopted in interpretation of treaties are not the same as those in interpretation of statutory legislation. While commenting on the interpretation of a treaty imported into a municipal law, Francis Bennion observes:

"With indirect enactment, instead of the substantive legislation taking the well-known form of an Act of Parliament, it has the form of a treaty. In other words the form and language found suitable for embodying an international agreement become, at the stroke of a pen, also the form and language of a municipal legislative instrument. It is rather like saying that, by Act of Parliament, a woman shall be a man. Inconveniences may ensue. One inconvenience is that the interpreter is likely to be required to cope with disorganised composition instead of precision drafting. The drafting of treaties is notoriously sloppy usually for very good reason. To get agreement, politic uncertainty is called for.

.....The interpretation of a treaty imported into municipal law by indirect enactment was described by Lord Wilberforce as being 'unconstrained by technical rules of English law, or by English legal precedent, but conducted on broad principles of general acceptation. This echoes the optimistic dictum of Lord Widgery CJ that the words 'are to be given their general meaning, general to lawyer and layman alike... the meaning of the diplomat rather than the lawyer."

An important principle which needs to be kept in mind in the interpretation of the provisions of an international treaty, including one for double taxation relief, is that treaties are negotiated and entered into at a political level and have several considerations as their bases. Commenting on this aspect of the matter, David R. Davis in Principles of International Double Taxation Relief , points out that the main function of a Double Taxation Avoidance Treaty should be seen in the context of aiding commercial relations between treaty partners and as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect of income falling to be taxed in both jurisdictions. It is observed (vide para 1.06):

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"The benefits and detriments of a double tax treaty will probably only be truly reciprocal where the flow of trade and investment between treaty partners is generally in balance. Where this is not the case, the benefits of the treaty may be weighted more in favour of one treaty partner than the other, even though the provisions of the treaty are expressed in reciprocal terms. This has been identified as occurring in relation to tax treaties between developed and developing countries, where the flow of trade and investment is largely one way.

Because treaty negotiations are largely a bargaining process with each side seeking concessions from the other, the final agreement will often represent a number of compromises, and it may be uncertain as to whether a full and sufficient quid pro quo is obtained by both sides."

And, finally, in paragraph 1.08:

"Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally."

Based on these observations, counsel for the appellants contended that the preamble of the Indo-Mauritius DTAC recites that it is for the "encouragement of mutual trade and investment" and this aspect of the matter cannot be lost sight of while interpreting the treaty.

Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc.

Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit". Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty.

Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage

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capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses.

There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy.

Rule in McDowell

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 which 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.

In the classic words of Lord Sumner in IRC V. Fisher's Executors ,

"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 any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame."

Similar views were expressed by Lord Tomlin in IRC v. Duke of Westminster which 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 taxgatherers may be of his ingenuity, he cannot be compelled to pay an increased tax."

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These were the pre second world war sentiments expressed by the British Courts. It is urged that McDowell has taken a new look at fiscal jurisprudence and "the ghost of Fisher (supra) and Westminster have been exorcised in the country of its origin". It is also urged that McDowell's radical departure was in tune with the changed thinking on fiscal jurisprudence by the English Courts, as evidenced in W.T. Ramsay Ltd. v. IRC , Inland Revenue Commissioners v. Burman Oil Company Ltd and Furniss v. Dawson .

As we shall show presently, far from being exorcised in its country of origin, Duke of Westminster continues to be alive and kicking in England. Interestingly, even in McDowell , though Chinnappa Reddy,J., dismissed the observation of J.C. Shah,J. in CIT v. A. Raman and Company based on Westminster and Fisher's Executors , by saying "we think that the time has come for us to depart from the Westminster principle as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J., and similar observations made elsewhere", it does not appear that the rest of the learned Judges of the Constitutional Bench contributed to this radical thinking. Speaking for the majority, Ranganath Mishra,J,(as he then was) says in McDowell :

"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."

(Emphasis supplied)

This opinion of the majority 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 liberally or principally, 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 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 (as he then was).

The basic assumption made in the judgment of Chinnappa Reddy,J. in McDowell that the principle in Duke of Westminster has been departed from subsequently by the House of Lords in England, with respect, is not correct. In Craven v. White the House of Lords pointedly considered the impact of Furniss , Burma Oil and Ramsay . The Law Lords were at great pains to explain away each of these judgments. Lord Keith of Kinkel says, with reference to the trilogy of these cases, (at p.500):

" My Lords, in my opinion the nature of the principle to be derived from the three cases is this : the court must first construe the relevant enactment in order to ascertain its meaning; it must then analyse the series of transactions in question, regarded as a whole, so as to ascertain its true effect in law; and finally it must apply

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the enactment as construed to the true effect of the series of transactions and so decide whether or not the enactment was intended to cover it. The most important feature of the principle is that the series of transactions is to be regarded as a whole. In ascertaining the true legal effect of the series it is relevant to take into account, if it be the case, that all the steps in it were contractually agreed in advance or had been determined on in advance by a guiding will which was in a position, for all practical purposes, to secure that all of them were carried through to completion. It is also relevant to take into account, if it be the case, that one or more of the steps was introduced into the series with no business purpose other than the avoidance of tax.

The principle does not involve, in my opinion, that it is part of the judicial function to treat as nugatory any step whatever which a taxpayer may take with a view to the avoidance or mitigation or tax. It remains true in general that the taxpayer, where he is in a position to carry through a transaction in two alternative ways, one of which will result in liability to tax and the other of which will not, is at liberty to choose the latter and to do so effectively in the absence of any specific tax avoidance provision such as s.460 of the Income and Corporation Taxes Act, 1970.

In Ramsay and in Burmah the result of application of the principle was to demonstrate that the true legal effect of the series of transactions entered into, regarded as a whole, was precisely nil."

Lord Oliver (at p.518-19) says:

"It is equally important to bear in mind what the case did not decide. It did not decide that a transaction entered into with the motive of minimising the subject's burden of tax is, for that reason, to be ignored or struck down. Lord Wilberforce was at pains to stress that the fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides (see (1981) 1 All ER 865, (1982) AC 300 at 323). Nor did it decide that the court is entitled, because of the subject's motive in entering into a genuine transaction, to attribute to it a legal effect which it did not have. Both Lord Wilberforce and Lord Fraser emphasise the continued validity and application of the principle of IRC v. Duke of Westminster (1936) AC 1 (19350 All ER Rep.259, a principle which Lord Wilberforce described as a 'cardinal principle'. What it did decide was that that cardinal principle does not, where it is plain that a particular transaction is but one step in a connected series of interdependent steps designed to produce a single composite overall result, compel the court to regard it as otherwise than what it is,

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that is to say merely a part of the composite whole."

Lord Oliver (at p.523) observes:

"My Lords, for my part I find myself unable to accept that Dawson either established or can properly be used to support a general proposition that any transaction which is effected for the purpose of avoiding tax on a contemplated subsequent transaction and is therefore 'planned' is, for that reason, necessarily to be treated as one with that subsequent transaction and as having no independent effect even where that is realistically and logically impossible."

Continuing, (at page 524) Lord Oliver observes:

"Essentially, Dawson was concerned with a question which is common to all successive transactions where an actual transfer of property has taken place to a corporate entity which subsequently carries out a further disposition to an ultimate disponee. The question is : when is a disposal not a disposal within the terms of the statute ? To give to that question the answer 'when, on an analysis of the facts, it is seen in reality to be a different transaction altogether' is well within the accepted canons of construction. To answer it 'when it is effected with a view to avoiding tax on another contemplated transaction' is to do more than simply to place a gloss on the words of the statute. It is to add a limitation or qualification which the legislature itself has not sought to express and for which there is no context in the statute. That, however, desirable it may seem, is to legislate, not to construe, and that is something which is not within judicial competence. I can find nothing in Dawson or in the cases which preceded it which causes me to suppose that that was what this House, was seeking to do."

Thus we see that even in the year 1988 the House of Lords emphasised the continued validity and application of the principle in Duke of Westminster .

While Chinnappa Reddy, J. took the view that Ramsay , was an authoritative rejection of principle in the Duke of Westminster , the House of Lords, in the year 2001, does not seem to consider it to be so, as seen from MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd . Lord Hoffmann observes:

"In the Ramsay case both Lord Wilberforce and Lord Fraser of Tullybelton, who gave the other principal speech, were careful to stress that the House was not departing from the principle in IRC v. Duke of Westminster (1936) AC 1, (1935) All ER Rep.259. There has nevertheless been a good deal of discussion about how the two cases are to be reconciled. How, if the various juristically

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discrete acquisitions and disposals which made up the scheme were genuine, could the House collapse them into a composite self-cancelling transaction without being guilty of ignoring the legal position and looking at the substance of the matter?

My Lords, I venture to suggest that some of the difficulty which may have been felt in reconciling the Ramsay case with the Duke of Westminster's case arises out of an ambiguity in Lord Tomlin's statement that the courts cannot ignore 'the legal position' and have regard to 'the substance of the matter'. If 'the legal position' is that the tax is imposed by reference to a legally defined concept, such as stamp duty payable on a document which constitutes a conveyance on sale, the court cannot tax a transaction which uses no such document on the ground that it achieves the same economic effect. On the other hand, if the legal position is that tax is imposed by reference to a commercial concept, then to have regard to the business 'substance' of the matter is not to ignore the legal position but to give effect to it.

The speeches in the Ramsay case and subsequent cases contain numerous references to the 'real' nature of the transaction and to what happens in 'the real world'. These expressions are illuminating in their context, but you have to be careful about the sense in which they are being used. Otherwise you land in all kinds of unnecessary philosophical difficulties about the nature of reality and, in particular, about how a transaction can be said not to be a 'sham' and yet be 'disregarded' for the purpose of deciding what happened in 'the real world'. The point to hold on to is that something may be real for one purpose but not for another. When people speak of something being a 'real' something, they mean that it falls within some concept which they have in mind, by contrast with something else which might have been thought to do so, but does not. When an economist says that real incomes have fallen, he is not intending to contrast real incomes with imaginary incomes. The contrast is specifically between incomes which have been adjusted for inflation and those which have not. In order to know what he means by 'real', one must first identify the concept (inflation adjustment) by reference to which he is using the word.

Thus in saying that the transactions in the Ramsay case were not sham transactions, one is accepting the juristic categorisation of the transactions as individual and discrete and saying that each of them involved no pretence. They were intended to do precisely what they purported to do. They had a legal

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reality. But in saying that they did not constitute a 'real' disposal giving rise to a 'real' loss, one is rejecting the juristic categorisation as not being necessarily determinative for the purposes of the statutory concepts of 'disposal' and 'loss' as properly interpreted. The contrast here is with a commercial meaning of these concepts. And in saying that the income tax legislation was intended to operate 'in the real world', one is again referring to the commercial context which should influence the construction of the concepts used by Parliament."

With respect, therefore, we are unable to agree with the view that Duke of Westminster is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah,J., in CIT v. Raman are very much relevant even today.

We may in this connection usefully refer to the judgment of the Madras High Court in M.V.Vallipappan and others v. ITO , which has rightly concluded that the decision in McDowell cannot be read as laying down that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement which is perfectly permissible under law, which has the effect of reducing the tax burden of the assessee, must be looked upon with disfavour. Though the Madras High Court had occasion to refer to the judgment of the Privy Council in IRC v. Challenge Corporation Ltd. , and did not have the benefit of the House of Lords's pronouncement in Craven , the view taken by the Madras High Court appears to be correct and we are inclined to agree with it.

We may also refer to the judgment of Gujarat High Court in Banyan and Berry v. Commissioner of Income-Tax where referring to McDowell , the Court observed:

"The court nowhere said that every action or inaction on the part of the taxpayer which results in reduction of tax liability to which he may be subjected in future, is to be viewed with suspicion and be treated as a device for avoidance of tax irrespective of legitimacy or genuineness of the act; an inference which unfortunately, in our opinion, the Tribunal apparently appears to have drawn from the enunciation made in McDowell case (1985) 154 ITR 148 (SC). The ratio of any decision has to be understood in the context it has been made. The facts and circumstances which lead to McDowell's decision leave us in no doubt that the principle enunciated in the above case has not affected the freedom of the citizen to act in a manner according to his requirements, his wishes in the manner of doing any trade, activity or planning his affairs with circumspection, within the framework of law, unless the same fall in the category of colourable device which may properly be called a device or a dubious method or a subterfuge clothed with apparent dignity."

This accords with our own view of the matter. In CWT v. Arvind Narottam , a case under the Wealth

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Tax Act, three trust deeds for the benefit of the assessee, his wife and children in identical terms were prepared under section 21(2) of the Wealth Tax Act. Revenue placed reliance on McDowell . Both the learned Judges of the Bench of this Court gave separate opinions.
Chief Justice Pathak, in his opinion said (at p.486):

"Reliance was also placed by learned counsel for the Revenue on McDowell and Company Ltd. v. CTO (1985) 154 ITR 148(SC). That decision cannot advance the case of the Revenue because the language of the deeds of settlement is plain and admits of no ambiguity."

Justice S. Mukherjee said, after noticing McDowell's case, (at page 487):

"Where the true effect on the construction of the deeds is clear, as in this case, the appeal to discourage tax avoidance is not a relevant consideration. But since it was made, it has to be noted and rejected."

In Mathuram Agrawal v. State of Madhya Pradesh another Constitution Bench had occasion to consider the issue. The Bench observed:
"The intention of the legislature in a taxation statute is to be gathered from the language of the provisions particularly where the language is plain and unambiguous. In a taxing Act it is not possible to assume any intention or governing purpose of the statute more than what is stated in the plain language. It is not the economic results sought to be obtained by making the provision which is relevant in interpreting a fiscal statute. Equally impermissible is an interpretation which does not follow from the plain, unambiguous language of the statute. Words cannot be added to or substituted so as to give a meaning to the statute which will serve the spirit and intention of the legislature."

The Constitution Bench reiterated the observations in Bank of Chettinad Ltd. v. CIT , quoting with approval the observations of Lord Russell of Killowen in IRC v. Duke of Westminster and the observations of Lord Simonds in Russell v. Scott

It thus appears to us that not only is the principle in Duke of Westminster alive and kicking in England, but it also seems to have acquired judicial benediction of the Constitutional Bench in India, notwithstanding the temporary turbulence created in the wake of McDowell .
Hence, reliance on Furniss , Ramsay and Burmah Oil by the respondents in support of their submission is of no avail.
The situation is no different in United States and other jurisdictions too.
The situation in the United State is reflected in the following passage from American Jurisprudence :
"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted. A tax-saving motivation does not

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justify the taxing authorities or the courts in nullifying or disregarding a taxpayer's otherwise proper and bona fide choice among courses of action, and the state cannot complain, when a taxpayer resorts to a legal method available to him to compute his tax liability, that the result is more beneficial to the taxpayer than was intended. It has even been said that it is common knowledge that not infrequently changes in the basic facts affecting liability to taxation are made for the purpose of avoiding taxation, but that where such changes are actual and not merely simulated, although made for the purpose of avoiding taxation, they do not constitute evasion of taxation. Thus, a man may change his residence to avoid taxation, or change the form of his property by putting his money into non-taxable securities, or in the form of property which would be taxed less, and not be guilty of fraud. On the other hand, if a taxpayer at assessment time converts taxable property into non-taxable property for the purpose of avoiding taxation, without intending a permanent change, and shortly after the time for assessment has passed, reconverts the property to its original form, it is a discreditable evasion of the taxing laws, a fraud, and will not be sustained."

Several judgments of the US Courts were cited in respect of the proposition that motive of tax avoidance is irrelevant in consideration of the legal efficacy of a transactional situation.

We may recapitulate the observations of the Federal Court in Johansson as to the irrelevance of the motive for Johansson. To similar effect are the observations of the US Court in Perry R. Bas v. Commissioner of Internal Revenue :

"we infer that Stantus was created by petitioners with a view to reducing their taxes through qualification of the corporation under the convention. The test, however, is not the personal purpose of a taxpayer in creating a corporation. Rather, it is whether that purpose is intended to be accomplished through a corporation carrying out substantive business functions. If the purpose of the corporation is to carry out substantive business functions, or if it in fact engages in substantive business activity, it will not be disregarded for Federal tax purposes."

In Barber-Greene Americas, Inc. v. Commissioner of Internal Revenue it was observed that a corporation will not be denied Western Hemisphere trade corporation tax benefits merely because it was purposely created and operated in such way as to obtain such benefits. Similarly, a corporation otherwise qualified should not be disregarded merely because it was purposely created and operated to obtain the benefits of the United States-Swiss Confederation Income Tax Convention.
Though the words 'sham', and 'device' were loosely used in

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connection with the incorporation under the Mauritius law, we deem it fit to enter a caveat here. These words are not intended to be used as magic mantras or catchall phrases to defeat or nullify the effect of a legal situation. As Lord Atkin pointed out in Duke of Westminster :

"I do not use the word device in any sinister sense; for it has to be recognised that the subject, whether poor and humble or wealthy and noble, has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax. The only function of a court of law is to determine the legal result of his dispositions so far as they affect tax."

Lord Tomlin said :

"There may, of course, be cases where documents are not bona fide nor intended to be acted upon, but are only used as a cloak to conceal a different transaction."

In Snook vs. London and West Riding Investments Ltd. Lord Diplock L.J., explained the use of the word 'sham' as a legal concept in the following words:

"it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities (see Yorkshire Railway Wagon Contracting State. V. Maclure (1882) 21 Ch.D.309 ; Stoneleigh Finance, Ltd. v. Phillips (1965) 1 All ER 513) that for acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived."

In Waman Rao and others v. Union of India & Ors. and Minerva Mills Ltd. and others v. Union of India and Ors. this Court considered the import of the word "device' with reference to Article 31B which provided that the Acts and Regulations specified Ninth Schedule shall not be deemed to be void or even to have become void on the ground that they are inconsistent with the Fundamental Rights. The use of the word 'device' here was not pejorative, but to describe a provision of law intended to produce a certain legal result.

If the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to treat the intervening legal steps as non-est based upon some

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hypothetical assessment of the 'real motive' of the assessee. In our view, the court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp.

The judgment of the Privy Council in Bank of Chettinad , wholeheartedly approving the dicta in the passage from the opinion of Lord Russel in Westminster , was the law in this country when the Constitution came into force. This was the law in force then, which continued by reason of Article 372. Unless abrogated by an Act of Parliament, or by a clear pronouncement of this Court, we think that this legal principle would continue to hold good. Having anxiously scanned McDowell , we find no reference therein to having dissented from or overruled the decision of the Privy Council in Bank of Chettinad. If any, the principle appears to have been reiterated with approval by the Constitutional Bench of this Court in Mathuram . We are, therefore, unable to accept the contention of the respondents that there has been a very drastic change in the fiscal jurisprudence, in India, as would entail a departure. In our judgment, from Westminster to Bank of Chettinad to Mathuram , despite the hiccups of McDowell , the law has remained the same.

We are unable to agree with the submission that an act which is otherwise valid in law can be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents.

In the result, we are of the view that Delhi High Court erred on all counts in quashing the impugned circular. The judgment under appeal is set aside and it is held and declared that the circular No. 789 dated 13.4.2000 is valid and efficacious.

We cannot part with this judgment without expressing our grateful appreciation to the Learned Attorney General, Mr. Harish Salve, Mr. Prashant Bhushan as also the party in person, Mr. S.K. Jha, all of whom by their industrious research produced a wealth of material and by their meticulous arguments rendered immense assistance.

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[1988] 144 ITR 146.
[1991] 190 ITR 626.
See also in this connection Leonhardt Andra Und Partner, Gmbh v. Commissioner of Income Tax
[2001] 249 ITR 418.
[1993] 202 ITR 508.
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Cases in Constitutional Law, D.L. Kier and F.H. Lawson, Pg.53-54, 159-163 (ELBS & Oxford University Press 5th Ed.).
See Section 5A of Central Excise Act, 1944 and Section 8(5) of the Central Sales Tax Act, 1956.
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[1971] 82 ITR 913.
[1999] 237 ITR 889 at 896.
[2001] 252 ITR 1.
[2002] 2 SCC 127 at para 11.
See in this connection State of Sikkim v. Dorjee Tshering Bhutia and Others (1991) 4 SCC 243 at para 16; N.B. Sanjana, Assistant Collector of Central Excise, Bombay and Others v. Elphinshone Spinning and Weaving Mills Co. Ltd.(1971) 1 SCC 337; B. Balakotaiah v. Union of India & Others (1968) SCR 1052 and Afzal Ullah v. State of U.P (1964) 4 SCR 991.
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