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# **LIFTING THE CORPORATE VEIL IN CASES OF TAX AVOIDANCE VS TAX EVASION IN INDIA: A CRITICAL ANALYSIS**

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## **ABSTRACT**

The foundation of contemporary corporation law is the idea of separate legal identity which was solidified in *Solomon v. Solomon & Co. Ltd.* This idea is not unqualified, though. In order to prevent corporate personality abuse, especially in situations involving tax fraud and avoidance, courts have developed the notion of lifting or penetrating the corporation veil. Tax evasion refers to unlawful ways to avoid paying taxes, whereas tax avoidance refers to legally acceptable ways to reduce tax obligations. This paper discusses how courts implement the notion of removing the corporate veil differently in each situation and critically investigates the differences between the two ideas in the Indian setting. The paper makes the case that the Indian courts take a careful but intentional approach, balancing the necessity to prevent legal abuse with the sanctity of corporate identity through judicial precedents, statutory interpretation, and changing policy concerns.

## **INTRODUCTION**

Corporate jurisprudence is based on the idea that a corporation is a distinct legal entity. It suggests that a business has separate rights and obligations from its directors and stockholders. However, this legal fiction can occasionally be used to avoid paying taxes and other legal duties. To reveal the true participants behind the company structure in these situations, courts apply the notion of lifting the corporate veil. One of the most important justifications for removing the corporate veil is taxation. Determining the judicial strategy requires understanding the difference between tax evasion and avoidance. Avoidance might be legal, but evasion is intrinsically dishonest and is subject to stringent legal scrutiny. This paper examines this difference and assesses how much Indian courts pierce the corporate veil in each situation.

## **CONCEPT OF CORPORATE VEIL**

The corporate veil doctrine is one of the pillars of the company law meaning that a company and its members are legally different. This theory which was well established in *Salomon v. Salomon & Co. Ltd.* acknowledges a company as a distinct legal personality and not a part of its shareholders and directors. This means that the personal liability of members is not normally transferred to the members of a company hence protecting them against liability. This principle underlies some fundamental attributes of a company such as limited liability, perpetual succession, and an independent legal personality. Limited liability guarantees the shareholders are not liable to any limit other than the amount they invested which spurs investment and risk-taking in the entrepreneurship. Perpetual succession keeps the company alive regardless of the change of membership but independent legal personality permits the firm to hold property, incur liabilities and sue or be sued in its own name.

The corporate veil is however not absolute and inviolable. It has been always known that the corporate form can be used to abuse or commit illegal acts. The judiciary in such a case is allowed to overlook the separate legal personality of the company and lift or even pierce the corporate veil to reveal the actual individuals behind the legal person. This is mostly the case when that company is being used as a scapegoat or a sham to commit fraud, evade legal requirements or act contrary to the common good.

The corporate veil doctrine is therefore, an essential exception to the rule of separate legal personality. It indicates the judiciary's determination to make sure that the corporate structure does not become a device of injustice, and at the same time the corporate structure does not lose its legitimate advantages of incorporation.

## **CORPORATE VEIL SHOULD BE LIFTED IN INSTANCES OF TAX EVASION**

Tax avoidance, in contrast to tax evasion, is in a much more complex and controversial area of tax jurisprudence. It is the application of legally allowable means to reduce the tax liability and it is usually done by structuring transactions and corporate entities in a strategic way. Such practices can take advantage of gaps or ambiguities in tax laws but they, in their strictest sense, do not breach the law. It is because of this difference that courts have traditionally taken a reserved and conservative approach with regard to tax avoidance. The doctrine of lifting the

veil of incorporation is not readily applied in such situations since that is likely to weaken genuine commercial planning and security of the corporate law. Meanwhile, courts are on watch over arrangements that, on the one hand, are legal on paper, but on the other hand, have the effect of evading tax payment. The big question on tax avoidance cases is when there is a legitimate tax planning or the colourable devices that disguise to be legitimate transactions. This has resulted in a sophisticated judicial practice, which aims at exploring the intent, content, and economic fact of corporate structures.

## KEY JUDICIAL PRECEDENTS

### **(a) Vodafone International Holdings BV v. Union of India.**

This was a landmark ruling that is the most authoritative decision on tax avoidance in India. The case was triggered by an international transaction of share transfer of a foreign company and as a consequence, the transfer of assets in India. The tax officials wanted to exercise capital gains tax by overlooking the corporate framework. However, the Supreme Court declined to do away with the corporate veil. It held that, Legitimate tax planning is permissible under the law, and The fact that a transaction leads to tax advantage cannot be ignored. The Court stated that a corporate form must be honoured in the event that it has a real business objective and it is not a formality. It warned against the adoption of a look through approach without any specific statutory approval, it said that such approach would cause uncertainty and discourage foreign investment. Notably, the Court drew a distinction between, Tax evasion (illegal), and Tax avoidance (can be legal). This case saw the trend to a form-respecting approach on the condition that the transaction is bona fide.

### **(b) McDowell and Co. Ltd. vs Commercial Tax Office.**

This was a more aggressive approach to tax avoidance as opposed to Vodafone. In a controversial ruling, the Supreme Court ruled that tax planning is only legitimate to the extent that it is operating within the confines of the law, but no colourable devices can be included in tax planning.

It was once remarked by Justice Chinnappa Reddy that Tax planning could be fair so long as it is in the context of the law. Colourable devices could not form a part of tax planning. The Court was highly disapproving of plans that were aimed at evading tax by artificial arrangements, and that the courts must not be complicit in the evasion of tax. Nevertheless, this case gave rise to a lot of ambiguity due to the general phrasing, as some people took the word as a denial of tax evasion in general. This stance was subsequently moderated and softened by

subsequent decisions, notably by Vodafone.

**(c) Union of India v. Azadi Bachao Andolan.**

This case was instrumental in re-establishing balance of the jurisprudence as regards tax avoidance. The Supreme Court had validated the India-Mauritius Double Taxation Avoidance Agreement (DTAA), which permitted some investors to channel investments through Mauritius to benefit in tax exemptions.

The Court did not accept the wide reading of McDowell and concluded that, It is not illegal in nature for tax avoidance. Not a single effort to plan taxation can be described as a colourable device.

It reinstated the idea that taxpayers have the right to organize their affairs to minimize tax liability provided such an arrangement is lawful. This ruling was a clear approval of form-based legality, which is open to lack of fraud or sham.

**Principles which arise out of the case law.**

An overview of judicial decisions shows that there is a range of subtle principles that apply to the lift-lift principle of the corporate veil in tax avoidance cases:

(i) The tax planning is legitimately planned.

Courts acknowledge that taxpayers are allowed to organize their matters in a tax-efficient manner. The simple cut in tax liability is not a reason to unveil the veil.

(ii) Difference between Avoidance and Evasion.

There is a strict separation between legal evasion and illegal evasion. Whether there is illegality/fraud is a conclusive mechanism in the veil piercing.

(iii) Commercial Substance Requirement.

Corporate forms have to have a true business intent. Such transactions that do not have commercial substance are likely to be disregarded.

(iv) Rejection of Colourable Devices

Artificial structures that are created with the sole aim of reaping tax advantages, and which do not make economic sense are considered impermissible and could result in veil lifting.

**(v) Judicial Restraint and Certainty**

Courts are hesitant to engage in too much intervention as they understand that uncertainty in tax treatment may discourage investment and destabilize business planning.

### **GAAR and Statutory Developments Role.**

The enactment of the General Anti-Avoidance Rules (GAAR) under the Income Tax Act, 1961 can be seen as a major change in the legal landscape of tax evasion in India. GAAR allows tax authorities to deprive tax benefits which come about as a result of impermissible avoidance arrangements.

Under GAAR, It is more about content than style, the transactions, which do not have commercial substance, can be ignored. Authorities can re-characterize arrangements to represent what they actually are. Nevertheless, GAAR has measures to guard against abuse as well, such as: Approval by a high-level panel, and Taking into account valid business reasons. In this way, GAAR codifies the principles that have been established by courts without infringing on the rights of the taxpayers.

### **Reason behind judicial restraint.**

The comparatively conservative stance of courts in cases involving tax avoidance is based on some key points. To begin with, commercial freedom must be safeguarded in a market-based economy. Businesses should be given freedom to make transactions in an efficient manner without unwarranted interference of tax authorities or courts.

Secondly, predictability and certainty in the tax law are essential in economic stability. The neglect of corporate structures may occur regularly and may bring about confusion, demotivating internal and external investors.

## **JUSTIFICATION OF JUDICIAL RESTRAINT**

The conservative and limiting stance which courts have assumed in matters of tax avoidance is not accidental or arbitrary; it is based on a row of persuasive legal, economic and constitutional reasons. In contrast to tax evasion, tax avoidance does not entail any form of blatant illegality, but rather it is conducted within the legal framework. In this regard therefore, a too aggressive judicial treatment of such cases would be tantamount to shaking the roots of corporate and tax jurisprudence.

To begin with, commercial freedom is safeguarded in a market-oriented economy. Business organisations work in an environment characterized by competition where efficiency, profitability, and strategic planning are key factors to survive and thrive. An acceptable part of such strategic decision-making is tax planning. By having courts systematically ignore the existence of corporate structures simply because it offers tax benefits, it would send a chilling

consequence to the business innovation and financial planning. The judiciary is thus restrained to make sure that legal economic activity does not face punishment because it is tax efficient. Second, predictability and certainty in the tax law is essential in ensuring economic stability and investor confidence. Companies, especially the multinational ones, invest in the long-term decision-making process, basing it on the current legal frameworks. This would create uncertainty in terms of the legal implications of corporate structures because of arbitrary or inconsistent judicial intervention in tax avoidance cases. Such uncertainty can discourage domestic and foreign investments, which has a negative impact on the economy. Courts help to maintain a stable and predictable legal environment by adhering to formally valid corporate structures.

Thirdly, the principle of legislative supremacy and separation of powers is of significance in decision making by the courts. Taxation is an essentially a question of law and the legislature has the mandate of determining and closing any loopholes in the tax regime. Courts have on numerous occasions admitted that they could not amend tax statutes in the name of interpretation. In the case of Union of India vs. Azadi Bachao Andolan, the Supreme Court pointed out that taxpayers may organize their affairs within the context of the law and it is not up to the judiciary to doubt the prudence of the legislative provisions. The constitutional boundaries between law-making and law-interpretation functions might be lost due to judicial overreach in this area. Fourthly, the promotion of economic growth and investment requires a sensible and moderate course of action. Tax benefits, exemptions and treaty benefits are usually brought into legal frameworks with the purpose of encouraging investment and promoting certain sectors of the economy. Through legitimate tax planning, businesses can avail themselves of these incentives thus contributing to economic growth. Over intervention in tax avoidance cases may lead to the defeat of these policy goals and discourage the use of legitimate tax benefits.

Besides these, the courts are also conscious of the necessity to uphold a distinction between the moral judgment and legal validity. Although some of these strategies of tax avoidance might not be ethically right, they might not be illegal. The courts have always avoided equating moral disapproval with the legal ban as they are fully aware that such decisions are within the prerogative of the legislative policy and not within the legal ruling. Moreover, judicial restraint is enlightened by the fact that it is difficult in practice to draw the line between the avoidance schemes that are legitimate and those that are impermissible. Contemporary business deals are

usually convoluted and multidimensional, featuring transnational frameworks, hierarchical bodies and complicated financial transactions. The interventionist approach may be too strict or interventionist and this may cause mischaracterization of true commercial transactions as avoidance devices. Thus, the courts would like to conduct a case-by-case examination, interfering only in the situations when the lack of commercial substance or the existence of a colourable device is proved. Essentially, the reasoning behind judicial restraint in cases where tax avoidance is involved can be viewed as a very delicate juggle between competing interests- to maintain the sanctity of the tax system and to protect commercial autonomy and economic development. Courts can make sure that the doctrine of lifting the corporate veil is not used regardless of circumstances by practicing care and focus on legality, substance and legislative intent. This restraining practice eventually strengthens the rule of law and stability of the economic system. Court Trends in India. Judicial treatment of the corporate veil in India, especially in respect of tax avoidance and tax evasion has been subjected to a tremendous evolution. The Indian courts have slowly shifted towards a formalistic and strict understanding of corporate personality, to a more subtle and purposeful approach that takes into account law and economic realities. This change can be explained by the attempts of the judiciary to balance the requirement of the prevention of abuse of corporate structures with the need to preserve commercial certainty and investor confidence.

### **Formal Difference between Avoidance and Evasion: Early Judicial Approach.**

During the early period of tax jurisprudence, the courts used to uphold a rigid and formal difference between tax avoidance and tax evasion. It was illegal and the courts could readily intervene by lifting the veil of incorporation, which was tax evasion. Conversely, tax evasion, technically within the law, was ever acceptable, even though it might lead to huge revenue loss to the State.

This practice was based on the fact that tax liability had to be strictly interpreted as per statutory requirements. The courts were not keen to interpret the tax laws beyond its face value and thus, taxpayers had a lot of room to organize themselves in a tax-friendly way. The focus was more on the form of law than the economic substance which in many cases allowed corporations to take advantage of loopholes in taxation laws.

### **Period of Transition: Colourable Devices Disapproved by the Courts.**

The tide started to change with rulings like, McDowell & Co. Ltd. v. Commercial Tax Officer,

in which the Supreme Court was highly critical of any kind of tax avoidance scheme that involved the application of artificial or colourable devices. The Court pointed out that tax planning in the context of the law is acceptable but schemes aimed at tax avoidance should not be promoted. This was a transitional period in judicial reasoning as courts started to doubt the validity of some practices in avoidance. But the sweeping and to some extent unintelligible terms in McDowell caused confusion, because it was not clear whether all types of tax avoidance were being criticized or only those which were devoid of substance.

## **CONTEMPORARY JUDICIAL STRATEGY SUBSTANCE OVER FORM**

There is a more refined and moderate trend in the modern judicial trend as it has been based on the emphasis of substance over form. In its turn, this does not mean that courts no longer examine the economic reality and commercial purpose behind corporate transactions and follow them, based solely on their legal structure. This strategy was well explained in the case of Vodafone International Holdings BV v. Union of India where it was stated by the Supreme Court that corporate structures must not be ignored as long as they are underpinned by legitimate business reasons and not sham structures. The Court declined to follow a blanket look-through approach, but instead applied a look-at principle, which considered the general circumstances and purpose of the deal. In a similar case, Union of India v. Azadi Bachao Andolan the Court affirmed that tax avoidance, per se, is not criminal, and taxpayers have the right to manage their affairs to reduce tax liability, so long as the arrangements are not illegal.

## **NEW DEVELOPMENTS AND TRENDS**

Over the last few years judicial trends show an increased degree of scrutiny on the complex corporate structures, especially globalization and cross-border transactions. Courts and tax authorities are becoming more acute with regard to investigating multilayered corporate structures, shell companies, and offshore companies that can be employed to conceal the reality of financial transactions.

The increased focus on economic content and business fact is also growing. When transactions are not genuinely business driven or are skewed towards tax concerns, they have higher chances of judicial intervention. This is in line with the global trend towards anti-avoidance practices which includes the introduction of the General Anti-Avoidance Rules (GAAR) in

India. Simultaneously, courts still exercise restraint, which is institutional, by not intervening in legitimate business decisions. The judiciary is aware that not every tax efficient structure is abusive and it is also wary not to:

De-incentivize investment, especially in an emerging economy in which foreign investment is vital, and Weaken corporate autonomy, which is one of the principles of company law.

### **BALANCING COMPETING INTERESTS**

The new trend in judicial decision-making can be interpreted as an effort to find a subtle balance between two fighting goals, On the one hand, it is necessary to - Prevent abuse of corporate structures, Safeguard public revenue, Make sure that you comply with the tax laws. On the other hand, courts must also, Keep sacred the corporate personality, Shield bona fide tax planning. Keep the economy stable and attract investors.

This balancing act is reflected in how the judiciary has been selective in applying the doctrine of the lifting of corporate veil- decisive in cases of tax evasion, but sparing and conditional in cases of tax avoidance. Conclusively, court tendencies in India show a gradual movement away of strict formalism to a more advanced, substance-based method. Although the early jurisprudence made a distinct distinction between tax avoidance and tax evasion, contemporary courts are aware of intricacies involved in corporate and tax structures. Initially focusing on economic reality with judicial restraint, Indian courts have come up with a pragmatic system that prosecutes abuse without suffocating real business. This emerging jurisprudence is indicative of the essential role of the judiciary in transforming the legal premises in line with the ever-changing demands of a contemporary economy.

he principle of the lifting of the corporate veil in the tax jurisprudence represents a longstanding conflict between two leading principles: the safeguarding of corporate personality and the guard against the abuse of law. On the one hand, the principle of separate legal entity, well established in *Salomon v. Salomon and Co. Ltd.* is an indispensable part of contemporary business, as it allows the establishment of limited responsibility, the ability to take risks and an efficient capital structure. Conversely, this separateness can also be used to create structures that distort reality and diminish the tax base. The difficulty to courts, then, is to balance intervention to ensure the doctrine is a shield to legitimate enterprise, rather than a sword to avoidance.

The reasons why the veil should be lifted in instances of tax evasion are fairly uncontroversial. In cases where there is sufficient demonstration that entities are sham, or this is done to hide income, judicial action is necessary and normative. *Juggilal Kamalapat v. Commissioner of Income Tax* is a decision that confirms the ability of courts to look past the outward appearance to inward reality and ignore artificial structures. Veil piercing in these circumstances enhances the integrity of the taxation system, discourages fraud, and safeguards the revenues of the people.

The more controversial is the ground of tax avoidance. In this case, the legality of the action is not questionable; however, the issue lies in whether arrangements that are formally legitimate should still be ignored because of their tax-driven nature. A judicial approach that is over aggressive will tend to break down the difference between avoidance and evasion- the same issue that was observed in *Union of India v. Azadi Bachao Andolan* where it was reiterated that taxpayers are entitled to organize the affairs so as to pay less tax. By piercing the veil every time a transaction produces tax benefits, the courts would negate the normal business planning and would contribute some subjectivity which is contrary to the rule of law.

No less important is the effect on certainty and investor confidence. Business players are guided by the fact that they can count on predictable legal results in how they organize a transaction, particularly in the cross-border scenario. This is emphasized in the warning in *Vodafone International Holdings BV v. Union of India* that an unprincipled look-through approach is unstable: unless there is an express statutory obligation to ignore corporate form, the practice of ignoring corporate form will interrupt settled expectations and discourage investment. In an evolving economy such uncertainty is physically costly to the macroeconomy.

However, too much respect for form is not in vain. Complex avoidance plans, including layered entity, treaty shopping and circular financing, may replicate commercial legitimacy, but will be effective in distressing the tax base. The caution in *McDowell and Co. Ltd. v. Commercial Tax Officer* that there should be no colourable devices is still relevant: judicial restraint cannot turn to judicial abdication. The assignment is to differentiate between legitimate tax planning and abusive avoidance that is often fact intensive and context specific.

Its subtle nature, however, requires a combination of objective factors: the existence of real business intent, the correspondence of the form and result to the economic substance, and the

reasonableness. Incorporation of anti-avoidance provisions like GAAR in the statutes represents an institutional solution to this dilemma, in that, it transfers main responsibility to the legislature, with the judiciary retaining an oversight role. Courts, in their turn, need to use veil lifting as a specific tool, which should be applied in situations where the corporate form is proven to be a mere pretense.

To conclude, the usefulness of the doctrine is in moderation. It has to be vigorous enough to break up abusive structures, but must be tamed enough to maintain the predictability and freedom necessary to business operations. It is only this kind of a fine-tuned approach that will be able to balance the dual demands of safeguarding the corporate form and ensuring that it is not abused in the tax law.

### **SUGGESTIONS AND REFORMS**

To successfully apply the doctrine of lifting the corporate veil in tax, a well-designed framework that does not cause ambiguity but still maintains the flexibility needed to deal with complicated corporate setups is needed. With the dynamic character of the tax evasion methods and the growing complexity of the corporate organization, the clarity of legislation, efficiency of administration, and consistency of the judiciary are obligatory. Among the most important reforms needed, there should be the establishment of clear and accurate statutory provisions that would separate tax avoidance and tax evasion. Currently, the difference is mostly based on judicial interpretation, resulting in confusion and unequal application. It would be desirable to have the clarity of codified objective criteria, which include commercial substance, bona fide business purpose, and economic reality. Such legislative articulation would also narrow down the room of subjective interpretation, which would make the operation of taxpayers and authorities within a predictable legal framework. This clarity would help reinforce compliance as well as minimize unnecessary litigation.

The General Anti-Avoidance Rules (GAAR) is a major move to curb the unacceptable tax avoidance. Nevertheless, their success largely depends on a consistent and transparent implementation. Strengthening GAAR requires Administrative guidance on when to determine the existence of impermissible avoidance arrangements. As well, GAAR is to be used in a way that it would differentiate between aggressive tax avoidance and proper tax planning. Excessive enforcement will discourage investment, whereas lax enforcement will not prevent abuse. Hence, a reasonable and ethical use of GAAR can go a long way towards minimizing judicial

discretion in lifting the corporate veil.

## JUDICIAL CONSISTENCY

The other urgent reform is the establishment of more judicial uniformity. Although some landmark cases like the case of Vodafone international holdings BV v. Union of India and the case of Union of India v. Azadi Bachao Andolan have clarified the important principles, there are still discrepancies in judicial reasoning based on cases. Courts ought to endeavour to come up with a standard set of principles to adopt in the process of lifting the corporate veil regarding taxation, especially concerning:

Identifying the sham or colourable devices  
Examining commercial substance  
Assessing intent and purpose  
Consistency of judicial decisions would contribute to predictability and confidence in the legal system. Emphasis on Substance Over Form There must be a long-term focus on the virtue of giving the principle of substance over form so as to make tax adjudication fair and effective. The courts and tax authorities should also be able to analyze the facts of the economic situation of transactions and not be restricted to their legal framework. This will eliminate tax evasion by taxpayers who take advantage of the technicalities of the law and the validity of a real business profit. Nonetheless, the use of this principle should be fine-tuned. A wide interpretation can result in an over-intervention in genuine dealings, and a narrow interpretation can not be used to identify complex avoidance arrangements.

## CONCLUSION

It is in the doctrine of lifting the corporate veil, that the principle of separate legal personality, introduced in *Salomon v. Salomon & Co. Ltd.*, is not abused as an instrument of lawlessness. Its use in the Indian context, in tax matters, shows a judicious and dynamic strike between two competing demands: the imperative to enforce the tax laws effectively and the imperative to maintain the autonomy of corporations and commercial certainty. There has also been a definite inclination by the courts in case of tax evasion to lift the veil when there are signs of fraud, a sham transaction or an intentional attempt to conceal the same. Meanwhile, judicial restraint in cases of tax avoidance is a sign of appreciation that lawful tax planning is a natural part of business strategy. The case of *Vodafone International Holdings BV v. Union of India* is one of the landmark cases that demonstrate the need to respect corporate structures that are substantiated by actual commercial purpose. Indian jurisprudence shows us the gradual, but unmistakable, movement toward a substance-over-form tradition, the Indian jurisprudence

tends more to emphasize economic reality than legal formalities. The practicality of the doctrine is, after all, in a thoughtful and judicious exercise of it, so that it does not repress sound business, but only authorizes abuses, by which the integrity of law and the economy of a country alike are preserved.

