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PIERCING THE CORPORATE VEIL IN TAXATION: JUDICIAL INCONSISTENCY IN ADDRESSING SHELL COMPANIES IN INDIA.

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ABSTRACT

The rule of piercing the corporate veil is a major exemption to the principle of separate legal personality in corporate law that permits the courts to look behind the facade of a legal person and see the individuals of a company. This concept has a considerable applicability in tax practice regarding shell companies that are often used as an instrument of tax avoidance to hide revenue, and make artificial financial structures. Though shell companies are not inherently illegal but when misused create significant challenges to regulatory bodies to ascertain positive ownership and to enforce tax liability.

This paper discusses the judicial review of the piercing of the corporate veil in India particularly in cases which involve shell companies. In discussing some notable cases such as *Sir Dinshaw Maneckji Petit v. Commissioner of Income Tax*, *McDowell and Co. Ltd. v. Commercial Tax Officer*, *Vodafone international Holdings BV v. Union of India* and *Delhi Development Authority v. Skipper Construction Co.*, the paper identifies the lack of a uniform judicial standard. There have been periods of strict sub-substance over form approach to the issue of tax avoidance followed by more restraint approach that defends temporary corporate structure and tax planning.

This inconsistency, the paper contends, is caused by the fact that no systematic analysis of the law has been conducted and as a result it relies on the imprecision of such notions as fairness, societal benefit and deceit. This gives loopholes to the tax law, promotes aggressive tax planning and litigation. It ends by reiterating the necessity of clearer judicial guidelines, regulatory reforms, necessary to guarantee the balanced and a foreseeable application of the doctrine in taxation issues.

Incorporated under corporate law, a company is a separate legal person, independent of the shareholders, and can own property; enter into contracts and be sued and sued in its own name. This principle of separate legal entity to which a company is attributed was introduced in Salomon v. Salomon & Co. Ltd. and it is the cornerstone of the modern company law and provides economic growth, as it means that the shareholders should not be liable.

KEYWORDS: Veil Piercing Doctrine, Shell Companies, Judicial Inconsistency, Seperate Legal Personality, Tax Evasion.

INTRODUCTION

It is a universal fact that the misuse of law fiction is possible. The corporate veil rule enables the courts to look beyond the personality of a company so that they may find out who is the owner of a company. It is particularly important when it comes to shell companies i.e. those that are operated on a paper level and have minimal or no real business activity. These firms are usually established to hide revenues, avoid tax payments or non commercial and fictitious operations.

In Indian context, shell companies have become more associated with linkage with intricate tax avoidance and evasion practices. Individual and corporations can conceal the nature of income and ownership by providing many layers of ownership structures and financial transactions taking place via several financial entities. It is hard to determine the true beneficiaries and impose obligations on the tax authorities in such situations and, therefore, the veil of the corporation in such situations only works as an efficient defense mechanism and as a possible weapon of abuse.

The judicial reactions to this abuse has been mixed. Courts have also resorted to being very stringent and in some instances lifting the corporate veil easily to avoid tax evasion and to discover those who are the true beneficiaries behind shell entities. In other instances, courts have been restrained in acknowledging the validity of tax planning structures and guarding the integrity of corporate personhood. This inconsistency indicates absence of clarity and uniformity in law in how the veil of incorporation ought to be lifted in taxation issues.

CONCEPTUAL FRAMEWORK

Even though the principle of separate legal personality is essential to the company law, the limitations on it are somewhat limited by the judicial ruling. One of such limitations is the doctrine of piercing the corporate veil that functions as an exception, but is not a rule in general. Instead of rejecting corporate identity completely, courts pick and choose to scrutinize the facts behind corporate structures where perseverance to establish form would thwart legal, or societal policy aims.

The use of this doctrine has greatly evolved with judicial interpretation which has resulted in establishing general recognition, but not fixed strictly defined grounds. Where there is a trade fraud or defeat statute, quotes have been the means where corporate structures have raised existing legal obligations, as a defense to defeat. This is presumed to be of specific relevance in the area of taxation since the line between a legitimate tax planning and an unacceptable tax evasion is oftentimes determined by the nature of transactions and not the form. Thus, courts are often forced to determine that a corporate set-up demonstrates a level of actual commercial operation rather than merely a way of evading liability.

In this case, the so-called substance over form approach is an important tool of analysis. According to this doctrine, the courts are interested in the economic fact that a transaction occurred more than the semblance of the law. By doing so the legal authorities will be able to review intricate structures of companies and even know the true character of the financial transactions. Nevertheless, it has been applied unevenly and there has been unequal application by courts to be willing to look beyond the formal legal framework of a company.

One of the significant differences under this doctrine is in the sense of concealment and evasion as outlined in *Prest v. Petrodel Resources Ltd.* Concealment is related to the situation when the corporate structure is used to disguise the names of real participants and evasion is the use of the corporate structure to avoid a duty of the law at hand. This difference is particularly relevant in tax cases in which judges have to determine whether a corporation is being used to merely cover-up ownership or to actively avoid paying taxes.

The lack of a formal structure regulating these principles have led to considerable judicial freedom. Consequently, the enforcement of the doctrine of veil piercing relies significantly on the specifics of each situations and interpretative method used by the judiciary. This

conceptual uncertainty becomes particularly troublesome in situations with intricate corporate frameworks where differentiating between a valid business practice and exploitative behaviours is inherently difficult. The inconsistency in enforcing these principles fundamentally contributes to the judicial uncertainty discussed in this paper.

SHELL COMPANIES & TAX EVASION

Shell companies which are legally incorporated entities are typically characterised by the absence of substantial amount of commercial operations or independent economic activity. In the Indian context, such entities are often used as an instrument for financial structuring rather than genuine business purposes. While the existence of such shell companies are not inherently unlawful, their utilisation becomes problematic when they are used to conceal financial transaction, obscure ownership patterns and to avoid statutory obligations¹.

One of the most common uses of shell companies in taxation matters is the routing of funds through layered structures of a company. By moving money between various parties that in some cases may be situated in other jurisdiction; individuals and corporations can leave a complicated trail of transactions that conceal the actual origin and destination of funds.

The establishment of artificial shareholding arrangements is one more way and means by which shell companies are used to carry out tax evasion. In these instances, the shares are registered in the name of intermediary parties who are simply nominees with the real control and benefit, of a different individual or group. This in fact enables the actual beneficiaries to separate themselves with taxable income and not be accountable directly to the latter. This is usually structured using corporate veil to conceal the true nature of the transactions of the company with no commercial goodwill.

Shell companies are also frequently used as a part of broader tax avoidance schemes whether the legal form is manipulated to achieve the outcome that will not be permissible if the substance of the transaction were considered. Such schemes can include in fictitious loans, overstated transactions or circle movement of funds that are meant to lessen taxable income. The company structure in such cases is not a passive structure, but it is an active tool which is used to engineer tax advantages.

¹ Rahul Mehta, *Piercing the Corporate Veil*, SSRN (2021), <https://ssrn.com/abstract=3850101>

Corporate veil is key to facilitating these practices since it establishes a legal distinction between the company and those who control it. This distance which is imperative to legal business activities can be also used to conceal the identity of the ultimate beneficiaries of the transactions. Consequently, the regulatory authorities face a big problem of establishing who is the real beneficiary behind a group of corporate entities.

The problem of identifying the beneficial ownership is exacerbated by the absence of the uniform standards of disclosure, and the existence of a number of the interrelated entities. Therefore, even in case dubious patterns are detected, it becomes legally difficult to establish the direct relationship between the individual and the source of incomes. It is in this grey area that the principle of the veil of incorporation being lifted takes relevance so as to enable the courts not only to pierce the corporate veil and to examine the true economic nature of these arrangements.

JUDICIAL APPROACH TO SHELL COMPANIES IN INDIA

The Indian courts have been instrumental in the development of the doctrine of lifting the corporate veil especially in taxation affairs of shell companies.. The method which has been taken by the court however is very inconsistent and dances around strict intervention and restraint by the court. This distinction can be seen through the analysis of the case loss in varied factual context.

A. Courts Piercing the Veil.

In cases involving tax evasion through artificial company structures, the courts have consistently adopted a strict approach by disregarding the separate legal personality of companies.

A foundational case in this record is *Sir Dinshaw Maneckji Petit v. Commissioner of Income Tax*. The assessee had incorporated several companies and diverted income to them in order to reduce his personal tax liability. They court held that these entities were not genuine business organizations but mere devices to avoid taxation and accordingly lifted the corporate veil².

This case reflects an ealy judicial recognition of shell companies used as an instrument to evade tax and establishes that corporate personality cannot be used to defeat tax laws.

² *Sir Dinshaw Maneckji Petit v. Comm'r of Income Tax*, (1927) 29 Bom LR 447 (India).

A similar principle was reinforced in *McDowell & Co. Ltd. v. Commercial Tax Officer*, where the Supreme Court condemned colourable devices used for tax avoidance. The court in this case held that while tax planning is permissible, it must not be a means to evade taxes through artificial structures³. This case firmly supports the principle of “substance over form”, reinstating that courts investigate the true nature of transactions instead of their legal façade.

Further in *S.R.M.S. Investments (P) Ltd. v. Commissioner of Income Tax*, the Supreme Court upheld the power of tax authorities to look beyond corporate entities and identify the real beneficiaries of income⁴. The court recognised that corporate structures may be used to conceal ownership and avoid tax liability thereby justifying the lifting of corporate veil.

B. Courts Protecting Corporate Structure.

In contrast, the courts have also adopted a restrained approach in cases where corporate structures are used for legitimate business or tax planning purposes.

In *Vodafone International Holdings BV v. Union of India*, the Supreme Court refused to disregard a complex corporate structure used in cross-border transactions. The Court held that legitimate tax planning is permissible and the mere existence of a tax advantage does not render a transaction invalid⁵. It also emphasized that unless a transaction is a sham or fraudulent, the corporate structure must be respected.

The Court introduced the principle of “look at” under which the transactions must be viewed in a holistic manner rather than dissected to impose tax liability artificially. This also reflects a strong judicial preference for certainty and predictability in corporate law.

Similarly, in *Life Insurance Corporation of India v. Escorts Ltd.*, the Supreme Court held that the corporate veil should not be lifted lightly and must only be disregarded in exceptional circumstances⁶. The Court emphasized that a separate legal personality is a fundamental principle and cannot be ignored merely because it appears convenient.

C. Fraud-Based Veil Piercing.

The most consistent judicial approach emerges in cases involving fraud where the

³ *McDowell & Co. Ltd. v. Commercial Tax Officer*, (1985) 3 SCC 230 (India).

⁴ *S.R.M.S. Invs. (P) Ltd. v. Comm’r of Income Tax*, (2005) 12 SCC 323 (India).

⁵ *Vodafone Int’l Holdings BV v. Union of India*, (2012) 6 SCC 613 (India).

⁶ *Life Ins. Corp. of India v. Escorts Ltd.*, (1986) 1 SCC 264 (India).

courts have shown zero tolerance for misuse of corporate personality.

In *Delhi Development Authority v. Skipper Construction Co.*, the company was being used as a vehicle to defraud buyers and also to divert funds through multiple entities. The Supreme Court held that the corporate veil can be lifted to identify the real persons behind the company and also prevent injustice⁷.

In this case, the court made it clear that corporate personality cannot be used as a shield for fraud and where companies have been formed as sham entities the courts will intervene decisively.

ANALYSIS

The above discussion of case laws reveals that the Indian judiciary does not follow an uniform or a predictable standard while dealing with the doctrine of piercing the corporate veil in taxation matters. Instead, the judicial decisions appear to be shaped by a combination of equitable consideration, policy concerns, and also factual interpretation rather than a clearly defined legal test. This has resulted in significant inconsistency and particularly in cases involving shell companies.

1. Absence of a Clear Legal Test

One of the most significant issues in this area is the absence of a coherent and a structured legal test which governs when the corporate veil should be pierced. The decisions are frequently justified by broad and flexible ideas, including: justice, public interest and fraud, which are usually used by courts. Although these principles are significant they are not precise and can give a wide range of judicial discretion.

An example of this is the case of *Delhi Development Authority v. Skipper Construction Co.* in which veil piercing was supported by the Supreme Court on account of averting injustice and fraud. Equally, in the case of *Life Insurance Corporation of India vs. Escorts Limited* the court stressed the fact that the doctrine should be used when there is need to administer justice.

Even though such formulations entail flexibility, they do not establish a standard of consistency. The enforcement of the doctrine, therefore, depends heavily on the subjective interpretations of the judge rather than a legal framework.

⁷ *Delhi Dev. Auth. v. Skipper Constr. Co.*, (1996) 4 SCC 622 (India).

2. Contradictory Judicial Outcomes

The inconsistency becomes more apparent when comparing the decisions in similar factual context, particularly in taxation matters.

In *McDowell & Co. Ltd. v. Commercial Tax Officer*, the Supreme Court adopted a strict stance against tax avoidance schemes, holding that courts must look beyond legal form and examine the substance of transactions⁸. This judgment strongly criticized, artificial arrangements of a company designed to evade tax and it also signalled a willingness to disregard corporate structures where necessary.

In contrast, In *Vodafone International holdings BV v. Union of India*, the Supreme Court adopted a far more lenient approach wherein the court upheld a complex corporate structure used in a cross-border transaction and it also emphasized that a legitimate tax planning is permissible⁹. It refused to disregard the corporate form in absence of a clear evidence of fraud or shame.

3. Challenges Posed by Shell Companies

This inconsistency is also worsened when it comes to shell companies. In contrast to blatant fraud cases, shell company schemes are often conducted within the confines of the law that it becomes hard to prove a wrongdoing beyond a reasonable doubt.

Shell companies typically involve:

- layered ownership structures
- indirect control mechanisms
- transactions, lacking commercial substance

These qualities are however not enough to establish fraud. Courts are thus at a crossroads:

- When they act too forcefully - danger of sabotaging legitimate business organizations.
- In case they are kept at bay - danger of allowing tax evasion.

In the example of Vodafone, the courts are reluctant to take a predetermined unlawfulness. This reluctance brings about loopholes to abuse since people are in a position to come up with advanced constructions which meet the right form as well as circumvent the intent of tax regulations. And therefore, not merely the use, but the fact

⁸ *McDowell & Co. Ltd. v. Commercial Tax Officer*, (1985) 3 SCC 230 (India).

⁹ Jonathan R. Macey & Joshua Mitts, *Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil*, 100 Cornell L. Rev. 99 (2014).

that proving intent is highly challenging and thus becomes the determining factor in court cases represents the flaw of shell companies.

4. Theoretical Perspective: Policy-Driven Veil Piercing

This discrepancy in judicial decision-making can be explained with the help of the theoretical design of Jonathan R. Macey and Joshua Mitts. They propose their interpretation of veil piercing as not falling under set legal principles, but rather, based upon some policy agenda.

The courts in their model are inclined to lift the veil of incorporation in three general circumstances:

1. To implement statutory or regulatory goals.
2. To prevent misrepresentation or misuse of corporate form
3. To encourage equity in the settlement of financial/insolvency disputes.

This is something that can happen as a result of this line of thought, as it is what offers light on why cases that seem quite similar can yield different results. Courts are not simply applying a doctrine of the law, but they are striking a balance between competing policy values like economic efficiency, fairness and regulatory enforcement. Courts are not merely applying a legal doctrine; they are balancing competing policy considerations such as economic efficiency, fairness and regulatory enforcement. The application of this theory to the Indian case law:

- In Mcdowell, the Court favored the enforcement of tax and interests of the people..
- The Court in the case of Vodafone was concerned with economic certainty, and investor confidence.
- In fraudulent matters such as the case of Skipper construction, the Court mainly focuses on right and wrongdoing.

This also implies that veil piercing is a policy driven as opposed to rule based.

Judicial treatment of the piercing of the corporate veil, in India especially regarding taxation, that uses shell companies, can be described as being inconsistent due to the lack of a distinct legal test and the competing policy factors. Although the courts are seeking to balance between deterring misuse on one hand and ensuring a sense of corporate autonomy on the other, the absence of formalized guidelines creates uncertainty and obscures the law. Lack of an organized judicial test permits shell companies to play in a grey area between legality and ill legitimacy.

IMPACT

This variable judicial methodology on the veil of incorporation in taxation cases has a big implication regarding both the legal predictability and the enforcement of the regulations in India. The lack of a standard poses a grey area in tax law that renders it more challenging to determine the legality of corporate organization beforehand on the part of tax payers and authorities.

This ambiguity promotes tax planning aggression where individuals and corporations are set up with convoluted schemes to take advantage of the fissure in judicial logic. Such an environment is specifically fertile to shell companies because they can be designed in a way that they do not face substantive scrutiny but meet the formal legal requirements.

In addition, the inconsistency also adds to the litigation since the tax authorities and taxpayers often differ on the interpretation of legality. Different treatments are common with similar transactions being subjected to disparate treatment based on the interpretation by the judiciary resulting in a protracted case and lacking uniformity.

The necessity to have certainty in tax legislation is needed to have investor confidence, as noted in the case of *Vodafone International Holdings BV v. Union of India*, but as seen in the case of *McDowell and Co. Ltd. v. Commercial Tax Officer*, the judiciary is also concerned with ensuring avoidance of tax evasion. The fact that these approaches coexist without a harmonised standard is a source of legal ambiguity in itself.

SUGGESTIONS

The issue of judicial inconsistency has to be resolved by creating a more managerial and foreseeable system that will regulate the doctrine of piercing the corporate veil in taxation cases.

To begin with, we need a legal test that clearly outlines what is considered to be a legitimate tax planning or illegitimate tax evasion. These attributes include economic substance, degree of control and intent behind the transaction that ought to be looked into in such a test.

Secondly, there should be special principles on how shell companies are identified and

controlled. These can involve increased disclosure of beneficial ownership, mandatory demonstration of commercial business and also closer examination of layered business constructions.

Thirdly, a stronger regulatory framework is necessary to complement judicial intervention. To solve the problem of misuse at an early stage, tax regulatory bodies and corporate organizations need to be given the power to spot and curb this misuse at an early stage by ensuring reliance on case-by-case judicial interpretation.

These reforms would be implemented to be able to minimize ambiguity and to make sure that the doctrine will be applied without necessarily undermining legitimate business activity.

CONCLUSION

The principle of lifting the veil of incorporation is a necessary measure against the abuse of the personality of corporations especially on the issue of taxation of the shell companies. Yet, the recent judicial trend in India is characterized as inconsistent due to the courts taking a lax and stringent stance with waves and turns in response to the facts and policy implications.

Although the flexibility enables courts to deliver equitable results, it also brings about uncertainty and unpredictability in the laws of taxation. The doctrine of piercing the corporate veil needs to be done more systematically, and with some uniformity, in order to balance the need to deter abuse with the protection in legitimate corporate operation.