CHAPTER VI
TAX INCENTIVES TO CHARITIES
AND TAX PLANNING

ROLE OF CHARITABLE TRUSTS IN SOCIALISTIC PATTERN OF SOCIETY

Article 38 of the Constitution of India enjoins the state to promote the welfare of the people, which in effect means that the state should look after the basic needs of its citizens, like medical care, education, relief of the poor and other similar objects.¹ No government has the financial resources to undertake all these charitable objectives and it is thus left to private philanthropy.

¹ Article 38 reads as under:

38. State to secure a social order for the promotion of welfare of the people: (1) The state shall strive to promote the welfare of the people by securing and protecting as effectively as it may a social order in which justice, social, economic and political, shall inform all the institutions of the normal life. (2) The state shall in particular, strive to minimise the inequalities in income and endeavour to eliminate inequalities in status, facilities and opportunities, not only amongst individuals but also amongst groups of people residing in different areas or engaged in different vocations.
to supplement these efforts. In order to encourage philanthropic activity in this area, the Government has given some tax concessions to these private organisations.  

Charity expresses certain postulates of Indian life, notably decentralised responsibility and voluntary action. Indian society has established a diversified pattern resting for financial support upon governmental and private sources. The variety of sources ensure diversity and distribution of control and responsibility. Philanthropy through its role in the private sector is indispensable for the maintenance of the variety of financial sources.

Tax exemption for bonafide charitable contributions and expenditures on charitable purposes reflects national support. Looking through the intricacies of tax codes and tax administration, one discerns the nature of the choice to be made. Private funds earned and owned by private citizens are subject to taxation. Charitable trusts require financial support. Tax codes may be used to encourage citizens to apply part of their private funds for charitable purposes, by providing tax incentives and exemptions to the citizens. In the alternative, the Indian people may use tax exemptions to absorb such funds into the government treasury and funnel them through the Government treasury for the charitable purposes, thus intensifying a current prospect that charitable trusts may become increasingly dependent upon the Government. It is the former choice, evidenced by the provisions for tax exemption, which the Indian people have made and to which they have adhered. By the choice, they have reaffirmed their commitment to voluntary action and widespread responsibility.

---

2 Bijawat Mahesh C. Charitable Purpose - Not involving the carrying on of any activity for profit - Retrospect & Prospect (unpublished)
Tax Incentive Provisions

Tax incentives in the form of exemptions and deductions are provided under the Income-tax Act, 1961. Under sections 10(21), 10(22), 10(22A) 10(23) and 10(23c) of the Act, income of certain charitable institutions and associations is exempt. Partial and full deductions are allowed to the assessees for the charitable contributions made by them to charitable organisations under sections 35, 35AC, 80G and 80GGA of the Income-tax Act.

Any income of educational institutions, \(^3\) hospitals, \(^4\) professional institutions \(^5\) existing solely for charitable purposes and not for the purposes of earning profit, is exempt from tax.

Any income of bodies or authorities established or constituted or appointed under any enactment or the administration of public religious or charitable trusts or endowments (including \textit{math}, temples, \textit{gurudwaras}, wakfs, churches, synagogues, agiaries or other public places of religious worship) or societies for religious or charitable purposes is exempt from tax.\(^6\)

Any income of scientific research association which is approved as a scientific research institution, \(^7\) any income of games associations established in India for the purpose of control, supervision, regulation or encouragement in India, of the games like cricket, hockey, football, tennis or such other games

---

3 Section 10(22) of the Income-tax Act, See Education
4 Section 10 (22A) of the Income-tax Act, See Medical relief.
5 Section 10(23A) of the Income-tax Act, See Object of general public utility.
6 Section 10 (23BBA) of the Income-tax Act.
7 Section 10 (21A) of the Income-tax Act.
or sports as the Central Government may notify in the Official Gazzette,\textsuperscript{8} and income of certain national funds\textsuperscript{9} including income of any other charitable fund or institution which is notified by the Central Government in the Official Gazzette\textsuperscript{10} and any trust or institutions, wholly for public religious purposes or wholly for religious and charitable purposes which is notified by the Central Government,\textsuperscript{11} is exempt from tax with the condition that the income of scientific research association, games association and income of notified charitable or religious trusts or institutions, is applied or accumulated solely to the purpose of the associations. Besides the modes of investment specified in section 11, the association is to invest or deposit its funds in any assets held by the association, in the form of corpus of the fund of the association as on 1.6.1973, or any assets (being debentures issued by or on behalf of any company or corporation) acquired by the association before 1.3.1983, or any accretion to the shares, forming part of the corpus of the fund of the association, by way of bonus shares allotted to the association, or voluntary contributions received and maintained in the form of jewellery, furniture etc. as notified by the Board.\textsuperscript{12}

In case of Scientific research association, exemption will not be available in relation to any income of such association being profits and gains of business and profession unless the business is incidental to the attainment of its objectives and separate books of accounts are maintained in respect of such business.

\textsuperscript{8} Section 10 (23) of the Income-tax Act.
\textsuperscript{9} Section 10 (23C) of the Income-tax Act.
\textsuperscript{10} Section 10(23C) (iv) of the Income-tax Act
\textsuperscript{11} Section 10(23C) (v) of the Income-tax Act
\textsuperscript{12} Inserted to in sections 10(21), 10(23) and 10(23C) of the Income-tax Act, by the Finance Act, 1992 with effect from 1.4.1990
Under the Income-tax Act, 1961 certain incentives are provided to stimulate contributions to charitable organisations. Under section 80G of the Act, the relief is allowable to the donors to reduce their taxable incomes by a part or full amount of the donations to any secular charitable fund or institution established in India provided it fulfils the specified conditions.13

13 Section 80G (5) provides the following conditions: (i) where the institution or fund derives any income, such income would not be liable to inclusion in its total income under the provisions of sections 11 and 12 or clause (22) or clause (22A) clause (23) or clause (23AA) or clause (23C) of section 10: Provided that where an institution or fund derives any income, being profits and gains of business, the condition that such income would not be liable to inclusion in its total income under the provisions of section 11 shall not apply in relation to such income, if - (a) the institutions or fund maintains separate books of account in respect of such business; (b) the donations made to the institution or fund are not used by it directly or indirectly, for the purposes of such business; and (c) the institution or fund issues to a person making the donation a certificate to the effect that it maintains separate books of account in respect of such business and that the donations received by it will not be used, directly or indirectly, for the purposes of such business; (ii) the instrument under which the institution or fund is constituted does not, or the rules governing the institution or fund do not, contain any provision for the transfer or application at any time of the whole or any part of the income or assets of the institution or fund for any purpose other than a charitable purpose; (iii) the institution or fund is not expressed to be for the benefit of any particular religious community or caste; (iv) the institution or fund maintains regular accounts of its receipts and expenditure; and (v) the institution or fund is either constituted as a public charitable trust or is registered under the Societies Registration Act, 1860 (21 of 1860), any law corresponding to that Act in force in any part of India or under section 25 of the companies Act, 1965 (1 of 1956), or is a University established by law, or is any other educational institution recognised by the Government or by a University established by law, or affiliated to any University established by law, or is an institution appoved by the Central Government for the purposes of clause (23) of section 10, or is an institution financed wholly or in part by the Government or a local authority; (vi) in relation to donations made after the 31st day of March, 1992 the institution or fund is for the time being approved by the commissioner in accordance with the rules made in this behalf: Provided that any approval shall have effect for such assessment year or years, not exceeding three assessment years, as may be specified in the approval.
An institution or fund established for the benefit of Scheduled Castes, backward Classes, Scheduled Tribes or of women and children shall not be deemed to be an institution or fund expressed to be for the benefit of a religious community or caste as provided in the specified conditions.  

The amount of charitable contributions that qualifies for the tax incentive is subject to a ceiling in the case of some of the recipient charitable organisations and any amount of contributions qualifies for the incentive in the case of other organisations. Therefore, for the purpose of a description of the tax incentive provisions, the recipient charitable organisations could be classified into two broad categories depending on the ceiling on the amount of contributions that qualifies for tax incentive. Category I consists of those organisations to whom the contributions qualify for the tax incentive subject to a ceiling,15 and category II consist of the rest of the organisations.16

The charitable organisations covered under category I are, the National Defence Fund, the Jawahar Lal Nehru Memorial Fund, the Prime Minister's Drought Relief Fund, the Prime Minister's National Relief Fund, the Prime Minister's Armenia Earthquake Relief Fund, the Africa (Public Contributions - India) Fund, the

---

14 *ExplanationI* to Section 80 G (5) of the Income-tax Act, 1961;

15 Section 80G(1)(i) : Where the aggregate of the sums of donations to the Prime Minister's National Relief fund or the Prime Minister's Armenia Earthquake Relief Fund or the Africa (Public Contributions - India) Fund or the Government or to any such local authority, institution or association as may be approved in this behalf by the Central Government, to be utilised for the purpose of promoting family planning, thereof, an amount equal to the whole of the sum or, as the case may be, sums of such nature plus fifty per cent of the balance of such aggregate;

16 Section 80 G (i) (ii) : In any other case, an amount equal to fifty per cent of the aggregate of the sums of donations.
National Children's Fund, the Indira Gandhi Memorial Trust, the Rajiv Gandhi 
Foundation, those approved or notified by the Central Government for the purposes 
of promoting family planning.\textsuperscript{17} Category II includes donations paid for the renovation 
or repair of any temple, mosque, gurudwara, church or other place as is notified 
by the Central Government in the Official Gazette to be of historic, archaeological 
or artistic importance or to be a place of public worship of renown throughout any 
State or States.\textsuperscript{18}

The ceiling on the amount of contributions that qualifies for the tax 
incentive, in the case of contributions to category I organisations, is calculated 
as a minimum of ten per cent of the gross total income.\textsuperscript{19}

A public religious fund or institution is charitable on general principles, 
and a donation made before 1st April 1964 to such a fund or institution qualified for 
tax relief, provided the fund or institution was non-communal in character.\textsuperscript{20} In view, 
however, of the Explanation 3 to section 80G of the Act, such a donation made after 
1st April, 1964 is no longer entitled to tax benefit since the expression "Charitable

\textsuperscript{17} Section 80G (2) (a) of the Income tax Act, 1961.

\textsuperscript{18} Section 80G(2) (b) of the Income tax Act,1961.

\textsuperscript{19} Section 80G(4) reads : Where the aggregate of the sums referred to in sub-clauses (iv) any other 
fund or any institutions to which this section applies; (v) the Government or any local authority, 
to be utilised for any charitable purpose other than the purpose of promoting family planning; 
(vi) any authority constituted for housing accommodation or for town planning; and (vii) any 
authority promoting family planning; of clause (a) and in clause (b) of sub-section (2) exceeds 
ten per cent of the gross total income (as reduced by any portion thereof on which income-tax 
is not payable under any provision of this Act and by any amount in respect of which income-tax 
is to be allowed under sub-section (1)).

\textsuperscript{20} Thangaswamy Chettiar v. CIT (1965) 57 ITR 546;
"purpose" for the purpose of the said section does not include any purpose the whole or substantially the whole of which is of a religious nature.\(^21\)

It is not necessary, in order to claim deduction under section 80G, that donations should be made to an established trust. Even initial donation made to a charitable trust, for the purpose of starting or founding the trust would also qualify for deduction.\(^22\)

Explanation 5, which was inserted by the Finance Act, 1976 with effect from 1st April, 1976 provides that no deduction shall be admissible under section 80G in respect of any donation unless such donation is of a sum of money. Upto the assessment year 1975-76, the section also covered donations in kind.\(^23\) The donation of a fixed deposit receipt would qualify for a deduction under this section, because it represents a sum of money though it is not cash.\(^24\)

\(^{21}\) CIT v. Upper Ganges Sugar Mills Ltd (1985) 154 ITR 308 at p.313;
\(^{22}\) CIT v. Ramniwas Karwa (1978) 112 ITR 433;
Rebate on income from new industry and donations to charity are allowed in the hands of a registered firm. But where a registered firm has been allowed relief from tax on donations for charitable purposes, such relief cannot again be allowed to the partners of the firm in their individual assessments.

While sub-section 3 of section 80G enacts that no deduction shall be allowed if the aggregate of the donations made in a year is less than Rs.250/-, sub-section 4 read with section 80B (5) lays down the maximum limit upto which donations qualify for tax relief. But the maximum limit does not apply to the funds and trusts mentioned in sub-section 2(a)(i) to (iii-c).

Incentives in respect of certain donations for scientific research or rural development: From April 1, 1989 the contributions to Rural Development Fund

26 CIT v. General Textiles (1978) 111 ITR 727; Section 80A (3);
27 Deduction in respect of certain donations for Scientific research or rural development 80GGA.

(1) In computing the total income of an assessee, there shall be deducted, in accordance with and subject to the provisions of this section, the sums specified in sub-section (2).

(2) The sums referred to in sub-section (1) shall be the following, namely:-

(a) any sum paid by the assessee in the previous year to a scientific research association which has as its object the undertaking of scientific research or to a University, college or other institution to be used for scientific research: Provided that such association, University, college or institution is for the time being approved for the purposes of clause (ii) of sub-section (1) of section 35;

(aa) any sum paid by the assessee in the previous year to a university, college or other institution to be used for research in social science or statistical research: Provided that such university, college or institution is for the time being approved for the purposes of clause (iii) of sub-section (1) of section 35;

(b) any sum paid by the assessee in the previous year-

(i) to an association or institution, which has as its object the undertaking of any programme of rural development, to be used for carrying out any programme of rural development approved for the purposes of section 35CCA; or

(ii) to an association or institution which has as its object the training of persons for implementing programmes of rural development:
and to a trust or institution of national importance, undertaking scientific research, etc. will also qualify for the tax incentive. Assessees who have income taxable under the head "Business and Profession" are entitled to a deduction in respect of payments made to a scientific research association\(^\text{28}\) for rural development\(^\text{29}\) and for conserva-

\(\text{continued from previous page""}........

Provided that the assessee furnishes the certificate referred to in sub-section(2) or, as the case may be, sub- section (2A) of section 35 CCA from such association or institution;

(bb) any sum paid by the assessee in the previous year to a public sector company or a local authority or to an association or institution approved by the National Committee, for carrying out any eligible project or scheme:

Provided that the assessee furnishes the certificate referred to in clause (a) of sub-section (2) of section 35 AC from such public sector company or local authority or, as the case may be, association or institution.

*Explanation*: For the purposes of this clause, the expressions "National Committee" and "eligible project or scheme" shall have the meanings respectively assigned to them in the Explanation to section 35AC;

(c) any sum paid by the assessee in the previous year to an association or institution, which has as its object the undertaking of any programme of conservation of natural resources or of afforestation, to be used for carrying out any programme of conservation of natural resources or of afforestation approved for the purposes of section 35CCB:

Provided that the association or institution is for the time being approved for the purposes of sub-section (2) of section 35CCB;

(cc) any sum paid by the assessee in the previous year to such fund for afforestation as is notified by the Central Government under clause (b) of sub-section (1) of section 35CCB;

(d) any sum paid by the assessee in the previous year to a rural development fund set up and notified by the Central Government for the purposes of clause (c) of sub-section (1) of section 35CCA.

(3) Notwithstanding anything contained in sub-section (1), no deduction under this section shall be allowed in the case of an assessee whose gross total income includes income which is chargeable under the head "profits and gains of business and profession."

(4) Where a deduction under this section is claimed and allowed for any assessment year in respect of any payments of the nature specified in sub-section (2), deduction shall not be allowed in respect of such payments under any other provision of this Act for the same or any other assessment year.


\(^{29}\) Section 35CCA of the Income-tax Act, 1961.
tion of natural resources. Other assessees are entitled to a deduction under section 80GGA in respect of such payments.

**Deductions of payment made to institutions engaged in approved rural development programmes**

In order to involve the corporate sector in rural development, section 35CC was introduced in the Income-tax Act, in 1977, to provide for deduction of expenditure incurred on approved rural development programmes. To encourage participation by individuals and other assessees in rural development programmes, yet another section 35CCA was introduced in 1978 to allow deduction of payment made to institutions engaged in approved rural development programmes.

The Government stopped approving the programmes for rural development under section 35CC in March 1985. Prior to this, section 35CCA was amended by the Finance Act, 1983 and under the amended section payments made to institutions engaged in rural development programmes qualified for deduction in cases where the programmes were approved before 1st March, 1983. The amendment also provided that where the programme was approved before 1st March, 1983 and if the payment was made thereafter by an assessee, the deduction will be allowed in case of programmes, which *interalia* involved the work by way of construction of any schools, dispensaries, welfare centres, workshops, etc. and the work had commenced before 1st March 1983. By another amendment of section 35CCA made by the Finance Act, 1983 the assessees have been allowed deduction in respect of payments made to

---

National Fund for Rural Development set up by Government, in the computation of income derived from business or profession.

Both these sections 35CC and 35CCA were subsequently omitted by the Direct Tax Laws (Amendment) Act, 1987 with effect from 1st April 1989. The Direct Tax Laws (Amendment) Act, 1989 has although restored the provisions of section 35CCA, but without any modification as to the date of approval of rural development programmes can only contribute to the National Fund for Rural Development. On such contributions the assessee deriving income from business or profession are eligible for deduction under section 35CCA and other assessee under section 80GGA.

**Tax Incentives for Investment of Business Profits on Socio-Economic Development Schemes**

The government, in order to promote investment of business profits in areas where massive capital input in required for socio-economic development, has introduced a tax incentive scheme under section 35 AC of Income-tax Act allowing for full deduction of donations made for such causes.

---

31 Expenditure on eligible projects or schemes

35 AC (1) Where an assessee incurs any expenditure by way of payment of any sum to a public sect. or company or a local authority or to an association or institution approved by the National Committee for carrying out any eligible project or scheme, the assessee shall, subject to the provisions of this section, be allowed a deduction of the amount of such expenditure incurred during the previous year:

Provided that a company may, for claiming the deduction under this sub-section, incur expenditure either by way of payment of any sum as aforesaid or directly on the eligible project of scheme.

(2) The deduction under sub-section(1) shall not be allowed unless the assessee furnishes along
One of the main eligibility criteria for securing full exemption under the section is that the benefit of the project or schemes should flow to the public in general or to individuals belonging to the economically weaker sections of the society. Public or private sector companies can also claim exemption for amount spent on such schemes, provided these are approved by the National Council.

The Tax Reforms Committee, (commonly known as Chelliah Committee) in its interim Report recommended:

"12.8 The provisions of sections 35AC, 35CCA, 35CCB and 80GGA should be amalgamated with section 80G. The 100 per cent deduction at present allowable under sections 35AC, 35CCA, 35CCB and 80GGA should be restricted to 50 percent as in the case of deduction for other donations under section 80G. Further, deductions should be allowed only in respect of donations to an approved association/institution and not for expenditure incurred on an in-house programme." 32

The recommendations made by the Tax Reforms Committee if implemented, will prove a set back on those social welfare programmes for which the Government is trying its level best to involve the business houses to invest their business profits, by giving 100 per cent deductions to the assessees. At present, the government, in order to promote investment of business profits in areas in which massive capital input is required for socio-economic development, has introduced a tax incentive scheme under section 35AC of the Income-tax Act, allowing for full deduction of donations made for such cases. Because of these tax incentive scheme, the response of companies, charitable trusts and voluntary organisations is overwhelming. The Government in its wisdom has rightly not implemented these recommendations of the Chelliah Committee while presenting the Finance Bill, 1992 on floor of the House on 29th Feb 1992 though the recommendations made by Tax Reforms Committee (commonly known as Chelliah Committee) were available to the Government before finalising the Finance Bill, 1992. It is suggested that Government should vigorously pursue the implementation of provisions contained in sections 35CCA and 35AC of the Income-tax Act.

**Incentives - Their practical application**

Private enterprise, which dominates economic activity in the country ignore the fact that they have responsibilities towards society too. But now they are waking up to their social responsibilities -not as a class but as individuals. Farsighted businessmen are adjusting their philosophies and trying to mould themselves in keeping with the emerging trends in economic thinking. But the adjustments are more in the nature of grudging concessions. The idea has not yet come to dominate the thinking of private enterprise. The private sector still believes in the theory of *laissez-faire*, and considerations other than profit are hardly given a thought.

231
The Tata group of industries has incorporated a social obligation clause in its Article of Association itself. The Tata Institute of Fundamental Research, The Tata Institute of Social Welfare and the National Metallurgical Laboratory are shining examples of the new outlook.

Under a unique rural development programme organised jointly by the Associated Cement Corporation, the Mafat Lal group of Industries, and the Hindustan Lever, training is provided to landless labourers for setting up cottage industries. Farmers get advice and guidance for increasing crop yields. Schools and creches have been opened in adopted villages.

The Birla group has established a trust for promoting educational research and running academic institutions. Indian Explosives have been helping the farmers in fighting crop diseases. Ferro-Alloys Corporation has built roads, dug wells and renovated school buildings in adopted villages. Mahindra & Mahindra provides finance and equipment for rural and agricultural development in Madhya Pradesh.

The farmers of Eteh village in Uttar Pradesh get high yielding seeds, supplied by the National Seed Corporation, at cost price with the help of Hindustan Lever. This company has also helped villagers in setting up bio-gas plants. Adivasis of Chande, Maharashtra have benefitted by eye camps organised by Hindustan Lever.

Thus under sections 35AC, 35CCA and section 80GGA, that a company or a co-operative society that incurs expenditure on any programme of rural development and upliftment of economically weaker section of society, is entitled to full amount deductions in tax calculations.
National Committee for Promotion of Social and Economic Welfare

Very recently, the Finance Ministry has constituted the National Committee for Promotion of Social and Economic Welfare which has approved three schemes received from voluntary organisations engaged in upliftment of economically weaker sections of the society.

Donations made by companies and associations to these agencies, whose schemes have been approved by the National Council, would be exempted from paying income-tax allowing for full deduction of the entire such amount paid. The 14 member Council met under the chairmanship of Justice P.N. Bhagwati (Former Chief Justice of India) on 7th March 1992, to consider 10 applications received from voluntary agencies seeking such exemption out of which three cases have been approved relating to health care programme, educational and self employment programme for rural areas.33

A Study by National Institute of Public Finance and Policy

In the year 1989, the National Institute of Public Finance and Policy, New Delhi conducted a study analysing empirically the effects of the tax incentive in India.34 The tax incentive to stimulate charitable contributions has been liberalised and extended to contributions to various charitable organisations overtime. These

decisions have been based mainly on the belief that the tax incentive leads to a substantial increase in the contributions in relation to the loss in tax revenue rather than on proven faces.\textsuperscript{35}

**Tax avoidance, tax planning and Judicial activism**

While charitable trusts are playing a very special and prominent role in the society, they too have been used as a device of tax avoidance. This problem has not remained unnoticed and has received attention of the Government, now and then. The Tax Evasion Enquiry Committee, 1968 pointed out that "creation of trusts" constitutes one of the "tax dodging devices."

Under the Income-tax Act, a charitable trust can claim exemption on the investment of corpus funds into any shares of a company, even though for a long period of time, the trust funds may be invested and utilised for furthering the donor’s business interests, the income of the trust would, nonetheless, continue to enjoy exemption from tax.

There are judicial decisions\textsuperscript{36} wherein it has been held that if the dominant object of the trust was of a charitable nature and there is a provision in the trust deed that the needs of the relatives of the donor would given priority, such a trust is entitled to exemption given under section 11 of the Act even though entire income of charitable trust is spent only on the relations of the donor.

\textsuperscript{35} Ibid.

Further in cases where trust property consists of residential building, shop etc. and is occupied by the beneficiary or relatives of beneficiary, they continue to enjoy tax free benefit by either paying no rent or nominal rent fixed for such property.

Numerous studies have been made regarding tax ‘evasion’ and ‘avoidance’ tactics. The Direct Tax Enquiry Committee commonly known as *Wanchoo Committee* while discussing avoidance and evasion has analysed the two concepts as under:

"In an acquisitive society, it is more common for tax-payers to regard taxation as a burden and to seek all possible means to escape it. The distinction between ‘evasion’ and ‘avoidance’, therefore is largely dependent on the difference on the methods of escape resorted to some are instances of merely availing strictly in accordance with law the tax exemptions or tax privileges offered by the Government. Others are manoeuvres involving an element of deceit, misrepresentation of facts, falsification of accounts, including downright fraud. The first represents what is truly tax planning, the latter tax evasion. However, between these two extremes, there lies a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact circumvent it with a view to eliminate or reduce the tax burden. It is these methods which constitutes tax avoidance."

**McDowell doctrine and Tax planning**

Although *McDowell’s case* is now seven years old yet the doubts and fears in the minds of the tax payers and the tax planners are still prevailing and is being frequently used by the taxing authorities to their advantage as an effective instrument to discredit even legitimate transactions which may have the effect of reducing the

37 Direct Tax Enquiry Committee 1971, p. 69.
tax liability in the process. The general feeling is that after this judgement tax planning is no longer permissible. But a careful study of the judgement shows that there is really no drastic change in the approach to tax planning efforts.

In this case, Justice Ranganath Misra observed:

"Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges."  

In his separate judgment Justice O. Chinnappa Reddy observed:

"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."

39 Ibid.

40 Ibid; The observations of Justice J.C. Shah as referred in McDowell's case are the following: In CIT v. Raman & Co. (1968) 67 ITR 11 (SC) J.C.Shah J. observed: "Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arise to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may be lawfully circumvented". and, in CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC) - "The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of the relationship. But the legal effect of a transaction cannot be displaced by probing into the 'substance of the transaction'.

236
Thus, Justice O. Chinnappa Reddy disapproved the well established principle laid by the Supreme Court in *CIT v. Raman & Co.* which guided for so long the judiciary and all concerned. He then further observed:

"In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it." (Emphasis supplied).

The authorities functioning under various tax enactments have started taking shelter under the above stated *Me Dowell* doctrine, to disallow even legitimate tax planning measures.

The facts of *McDowell's case* were that the assessee was a manufacturer of liquor and held D-2 licence. The assessee made sales of liquor to the buyers, who directly paid excise duty thereon to the Excise Department. The Sales Tax Department sought to include the excise duty so paid by the buyer in the appellants' turnover for levy of sales tax. The Supreme Court observed that the excise duty being an incidence on manufacture, was payable, by the manufacturer. The assessee was, however, entered into a settlement with his buyers whereby the excise duty liability was met by the buyers themselves. According to the Supreme Court, the duty paid by the buyer, was actually a part of the turnover of the assessee and, therefore, liable to be included while determining its sales tax liability.

41 (1967) 68 ITR 11 (SC).
42 Ibid.
As per the judgement of Justice Ranganath Misra, if the transactions are real and legal and there is no violation of law in any way then the tax planning is permissible. But Justice O. Chinnappa Reddy has laid down different criteria. According to him the test should be 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. If the transaction is considered to be a device to avoid tax then even the real and legal transaction will not get approval.

This observation, if read literally, may have devastating effect. If reduction of tax liability is the only consideration for not according approval by the judicial process, without any regard for the genuineness and legality of the transaction then formation of a partnership, partition of a family, reunion, creation of trust, a settlement, a gift, etc., may not be approved even though these are real and legal. Every such act may have the effect of reducing the tax liability, although the purpose behind such acts may not be reduction of tax liability. This was not perhaps the intention of Justice Chinnappa Reddy. The condition put by him is that the transaction should be such that the judicial process may accord its approval to it. But a transaction which is real and legal will not be disapproved by the judicial process. In this view of the matter it will not be wrong to infer that although the term ‘avoidance of tax’ has been used in the judgement, what is really meant is ‘evasion of tax’. This inference also gets support from the facts of the case in the background of which the judgement is given.

That means, how to ascertain whether the reduction of tax liability following from a transaction is the result of a genuine transaction or due to adoption of a

---

43 Ibid.
44 Bhattacharjee, N.G. McDowell's case - Much ado (1992) 104 CTR (Articles) 37 at p. 42;
device to avoid tax. In the regard, the Gujarat High Court in *CIT v. Sarkarlal, Balabhai*\(^4^5\) observed:

"Tax avoidance postulates that the assessee is in receipt of amount which is really and in truth his income liable to tax but on which he avoids payment of tax by some artifice or device. Such artifice or device may apparently show the income as accruing to another person, at the same time making it available for use and engagement to the assessee.... or mask the true character of the income by disguising it as capital receipt..... or assume diverse other forms.... But there must be some artifice or device enabling the assessee to avoid payment of tax on what is really and in truth his income. If the assessee parts with his income producing asset, so that the right to receive income arising from the asset which, therefore, belonged to the assessee is transferred to and vested in some other person, there is no avoidance of tax liability: no part of the income from the asset goes into the hands of the assessee in the shape of income or under any guise....."

Thus, a device adopted by a person to avoid payment of tax on taxable income, really received by or accruing to him, by apparently showing as accruing to another person or artifically disguising it as capital receipt or in any other manner, may be regarded as a device adopted to avoid tax. But where by entering into a transaction a person parts with his income producing asset in favour of another person and that other person thereafter receives the income, there is no avoidance of tax by the person. The real test, therefore, is whether income accruing to a person, really and legally, has been diverted by any artificial device. If that be so then it can be said that the device has been adopted to avoid tax. Such a device may not get judicial approval.\(^4^6\)

The reduction of liability does not lead to the conclusion that this is due to adoption of a device to avoid tax. If the Revenue can establish that a device has

\(^4^5\) *(1968) 69 ITR 186* affirmed by the Supreme Court in *CIT v. Vadilal Lalht Bhai* (1972) 86 ITR 2 (SC);

\(^4^6\) *Supra, "McDowell ado"* note 44
been adopted to avoid tax then only the opinion of Justice O. Chinnappa Reddy may be applied.

Regarding adoption of colourable device and resorting to dubious methods, pre-McDowell position was also the same. In *Jiyajeerao Cotton Mill Ltd. v. CIT & EPT*, the Supreme Court observed:

"Every person is entitled to so arrange his affairs as to avoid taxation but the arrangement must be real and genuine and not a sham or make believe...."

In *CIT v. A. Raman & Co.*, the Supreme Court held:

"By adopting a device, if it is made to appear that income which belonged to the assessee had been earned by some other person, that income may be brought to tax in the hands of the assessee...."

Thus, colourable devices and dubious methods never received judicial approval even prior to *McDowell's case*.

**McDowell Doctrine**

It follows from the *McDowell's case* that-

(a) tax planning is legitimate, provided it is within the framework of law,

(b) colourable devices cannot be part of tax planning.

---

47 (1958) 34 ITR 888 (SC);
48 (1968) 67 ITR 11(SC);
49 1985) 154 ITR 148 (SC).
(c) it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods,

(d) it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges;

(e) if a device is adopted to avoid tax then, although the transactions are real and legal, the judicial process may not accord its approval to the device, and

(f) probing into the substance of the transaction is permissible displacing the legal effect of the transaction.

Latest Position
The observation on moral aspect propagated in McDowell's case is of course something new. Justice O. Chinnappa Reddy observed:

"We now live in a welfare state whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation."

But this observation has not found favour even before the Supreme Court in a subsequent case of CWT v. Arvind Narottam. Justice Sabyasachi Mukherji in that case observed with reference to McDowell's case as under:

---

50 McDowell's case (1985) 154 ITR 148 at p.160 (SC);
51 (1988) 173 ITR 479 (SC);
"But the question which many ordinary taxpayers very often, in a country of shortages and ostentatious consumption and deprivation for the large masses, ask is, does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation of Government spending are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance."

To conclude, if the taxing statute provides various incentives through deductions, allowances, and exemptions, the assessee can legitimately claim all such deductions, allowances and exemptions which directly come to him through the applicability of those provisions. The courts can intervene only where the assessee has artificially manipulated his affairs through a series of transactions so that as an end result of all these the tax incidence finally gets reduced illegitimately. After McDowell's case, every transaction though legally valid but if it appears to the judicial authority that the transaction was made only for reduction of tax liability and was to no other commercial end, will be looked at with suspicion and will be examined by the Courts minutely and closely scrutinised. Therefore, tax planning is still legitimate provided it is within the framework of law and without any intention to avoid or evade taxes. While creating public charitable trusts the settlor should keep in mind the McDowell doctrine as explained in subsequent judgements.