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Corporate Tax Avoidance: Legality and Ethics of the Inevitable Corporate Practice

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Corporate Tax avoidance is legal or abuse of law. In this research paper, the important concept affecting a nation's economy is covered and analyzed which is 'Corporate tax avoidance'. Tax is a form of income for the government but is often avoided by corporations by using the loopholes and deficiencies in the law to maximize the revenue of the company. The main issue of whether this practice of tax avoidance is legal or an abuse of law is discussed and analyzed and the ethical dimension is also analyzed concerning this issue. The whole research is backed by statistical data presented on the study of corporate tax avoidance. So in this research analysis, the findings are based on the tax avoidance practices followed by the big corporate giants. The impact it is creating on the nation's economy and the effective measures taken by the government to prevent this practice of tax avoidance. Additionally, questions such as how are corporations able to avoid taxes legally, and what are they gaining by evading the taxes concerning the Indian and international context are also reviewed and discussed. The dissimilarity between corporate tax avoidance and tax evasion is also analyzed in detail. The corporate tax avoidance strategies and practices followed by big corporate firms are also analyzed with the help of cases and rulings that happened in the past.

Keywords: *corporate tax avoidance, corporate tax, tax evasion, ethical practice, tax havens, transfer pricing, anti-tax avoidance.*

INTRODUCTION

The corporate tax, often known as corporation tax or company tax, is frequently levied on the earnings or capital of certain categories of legal companies alternatively referred to as capital taxes or income taxes. The primary source of revenue for the government is tax and it is levied and collected in two ways direct and indirect taxes. The tax levied by the government on the corporation is by way of direct taxes which are collected directly on the total revenue of the company at a flat rate percentage.¹ In general, entities that are recognised as partnerships are not subject to entity-level taxation. Several nations tax all corporate profits made within their borders. Tax avoidance can be best defined as the taxpayers interpreting the object and intent of a provision made by legislation in a particular scenario for their benefit reducing or avoiding the payment of tax. Corporations exploit legal loopholes and strategies prevalent in the tax law to avoid paying taxes to the government and reduce tax liability significantly, these are not done illegally but rather legally by prioritizing investments that are beneficial for tax saving. Globally, large corporate firms dodge paying taxes to the tune of over INR 50,000 crores per year.

TAX AVOIDANCE VS TAX EVASION

Tax evasion and tax avoidance² though used synonymously is an entirely different concept. Tax avoidance is merely following the legal procedures and exploiting the loopholes in the law to reduce tax burden whereas tax evasion is a completely different concept in which the practice of evading tax in an illegal manner is considered against the law and if the committee is a punishable offence. tax evasion, a taxpayer must typically have the intention or presumed to have the intention not to pay the required taxes. Tax evasion consists of unlawful practices such as concealing revenue information from the tax department, misrepresenting and providing false information to the tax department, underreporting the income or revenue made by the company, and illegal ways of smuggling goods to avoid paying goods tax. These were some of

¹ Julia Kagan, 'Corporate Tax: Definition, Deductions, How It Works' (*Investopedia*, 22 January 2024)

<<https://www.investopedia.com/terms/c/corporatetax.asp>> accessed 22 January 2024

² Kagan J, 'What Is Tax Avoidance and How Is It Different from Tax Evasion?' (*Investopedia*, 13 December 2023)

<https://www.investopedia.com/terms/t/tax_avoidance.asp> accessed 22 January 2024

the practices that are done for the evasion of tax liability and the reduction of tax burden through illegal practices.

GENERAL PRACTICES OF TAX AVOIDANCE

Companies practice certain methods for reducing tax liability such as tampering with the **transfer pricing** to change profits less profit jurisdiction from a jurisdiction which has high tax rates. This process includes reducing the price of goods or services that are exchanged under different entities but under one company. In high-tax countries, by tampering with these prices companies can also reduce their tax burden significantly. **Tax havens** in which subsidiary companies are created by parent companies to reduce the tax or avoid tax burden completely in viable countries. By doing this the profits made under the tax havens can be completely brought back into the parent company without the tax burden. By doing this the profits made under the tax havens can be completely brought back into the parent company without the tax burden. eg \$10.7 billion is held abroad by Nike.³ Tax shelter situated in Bermuda and in case tax haven benefits had not been utilized, the company would have shelled out \$3.6 billion in taxes. This reflects that Nike pays just 1.4% of its offshore income in taxes to foreign countries, implying that almost all of the money is retained by Nike subsidiaries in tax havens. Goldman Sachs⁴ utilizes Bermuda as a tax haven and maintains \$28.6 billion in offshore assets. **Financing debt** is another method of practice under which the taxable income is reduced using debt financing. The tax-deductible option for the interest paid for the debt allows the company to avoid tax and the company may do this by borrowing capital for reducing its taxable income. The taxable income is reduced by taking advantage of the **intangible assets**. The profits of the parent company are transferred to the subsidiary company which holds the intangible assets such as patents, trademarks, and copyrights to charge high prices from other subsidiaries for utilizing the assets.

³ CFI Team, 'Tax Haven' (*Corporate Finance Institute*)

<<https://corporatefinanceinstitute.com/resources/economics/what-is-tax-haven/>> accessed 22 January 2024

⁴ *Ibid*

INDIAN PURVIEW

The Indian government has always taken the initiative to close and rectify gaps in the taxation legislation and its framework through the budget, revisions, recommendations, and agreements with other nations. However, the corporations and large business houses in this area are constantly a few steps ahead of the government in India, which is well-versed with cutting-edge experts who know ways to exploit trade relations with other nations, taxation rates, legal loopholes, deductions, and sometimes trade rates to lessen the tax burden imposed on their company without breaking the law. These enormous corporations can design the most complicated and elaborate schemes for the avoidance of tax, resulting in a significant loss of income for governments throughout the world. Some instances of significant Indian corporations that have perfected the practice of tax avoidance are Reliance India Limited⁵, Tata Industries, Vodafone, Google etc. The Income Tax Act of 1961 and Finance Act of 2015 were enacted and regulations and guidelines were implemented by the Indian government to prevent and curb tax avoidance practices and strategies. The General Anti-Avoidance Regulation⁶ (GAAR) was part of the Income Tax Act Chapter X-A added by the Budget Act 2012 and came into effect on April 1st, 2017. The Income Tax Act was amended to include a provision known as Section 96⁷. Impermissible avoidance arrangement with the express purpose of preventing avoidance of tax. The provision forbade contracts or transactions entered into to obtain a tax advantage.

To align with rules and regulations with the (Base Erosion and Profit Shifting) BEPS suggestion made by (The Organization for Economic Co-operation and Development) OECD, which could reduce the threat of tax avoidance, the Indian government in consonance to this took several actions in 2017.

⁵ 'All about Dhirubhai Ambani' (*Chartered Club*)

<<https://www.charteredclub.com/?s=All+about+Dhirubhai+Ambani>> accessed 18 January 2024

⁶ 'Clarifications on Implementation of GAR Provisions under the Income Tax Act, 1961' (*Government of India Ministry of Finance*, 27 January 2017)

<https://incometaxindia.gov.in/communications/circular/circular7_2017.pdf> accessed 18 January 2024

⁷ CHAPTER X-A GENERAL ANTI-AVOIDANCE RULE 2016

CORPORATE CASE STUDIES

Vodafone Company: This case⁸ is a great example of strategic corporate tax avoidance. Vodafone International Holdings B.V. based out of the Netherlands purchased a company in India using a complicated tax avoidance strategy by using a non-resident company to close the deal to restrain paying tax on capital gains levied in India. Hutch Essar was the company purchased by Vodafone and the non-resident company was its own subsidiary company run in another country. CGP is an international company based out of the Cayman Islands subsidiary of Hutchison Telecommunication International Limited (HTIL). The 67% controlling share of the hutch essar which lay with CGP International was automatically transferred to Vodafone International Holding B.V. In this way, the controlling stake of the hutch essar was purchased. Vodafone International Holdings were issued with the show cause notice by the income tax department challenging the deal which took place in response to which Vodafone International Holdings B.V. proceeded High Court challenging the notice issued by filing a writ petition. The high court dismissed and held that the company should pay the tax on capital gains as the sale transfer deal qualifies and captivate capital gains tax amounting to Rs 12000 crores. Vodafone International Holdings appealed to the 'Supreme Court of India' via a special leave petition challenging the decision passed by the high court order. In 2012, the apex court ruled that the High Court's interpretation lacked legal basis and should be annulled since the deal involved two Indian companies that were not residents. Hence, Vodafone was able to purchase Hutch Essar India without having to pay tax on capital gains.

Reliance India Limited: Reliance India Limited' was recognized as a 'Zero-tax company' until the year 1995 which means that a company displays profit accrued and also pays the dividends but does not pay taxes. The loopholes in the Indian taxation system were abused by Reliance India Limited⁹ to a great extent by avoiding taxes through subsidiaries that were in the business

⁸ 'Vodafone International Holding v. Union of India Case Review' (*Law Senate*)

<<https://www.lawsenate.com/case-studies/vodafone-international-holding-vs-union-of-india.html#>> accessed 17 January 2024

⁹ 'All about Dhirubhai Ambani' CHARTERED CLUB <<https://www.charteredclub.com/all-about-dhirubhaiambani/#:~:text=Zero%20Tax%20Company&text=even%20after%20%20decades%20of,was%20forced%20to%20pay%20taxes.>> accessed 18 January 2024

of making raw materials and components in countries that have low tax rates and Reliance which was the parent company purchased the raw materials 3 times more than the actual price to decrease the net income. All these practices were done only till the year 1997 after which the Indian government took the initiative of Minimum Alternative Tax to battle the zero tax companies and the concept of corporate income tax was introduced. Reliance India Limited was successful in the practices of corporate tax avoidance as in an audit it was found that Reliance India Limited followed many methods such as merger and demerger of group entities, related parties transactions, and transactions with subsidiary companies to avoid the tax burden.

TATA INDUSTRIES

One of the biggest corporations in the nation, Tata Industries¹⁰, avoided paying taxes by not declaring capital gains when it sold its stakes to the cellular service company Idea in 2007. Birla Company Holdings then purchased the shares from Tata Industries through a subsidiary called Apex, which is based in Mauritius. Income tax authorities discovered that the trade involved capital gains tax of INR 1,00,000 crore which was avoided by violating Section 93¹¹ of the Income Tax Act, but they concluded that Tata was exempt from paying capital gains tax because the income tax appellate tribunal determined that no assets were transferred from a tax-reporting company in India to a non-tax-reporting company. Hence data cannot be taxed on the capital gains arising from a deal of Idea company closed by its Mauritius-based sub-company. Renowned Industries TATA has also avoided tax through many other ways such as the several charitable trusts owned by them which have tax exemption privileges that were used to create fixed assets for making more profits rather than for the original purpose of charity.

LEGAL PRECEDENTS RELATING TO TAX AVOIDANCE

CIT v A. Raman Co:¹² In this decision, the Supreme Court ruled that it is not illegal to arrange commercial activities such that tax charges are spread to avoid paying taxes. The taxpayer has

¹⁰ Siddhartha Sain, 'Is Tax Avoidance Legal in India?' (*iPleaders*, 30 April 2018) <<https://blog.ipleaders.in/tax-avoidance-corporations-india/>> accessed 18 January 2024

¹¹ CHAPTER X-A GENERAL ANTI-AVOIDANCE RULE 2016

¹² *Commissioner of Income-Tax v A. Raman & Company* 1969 SCR (1) 10

the option to use a tool to redirect revenue before it becomes his. The way the Act works will determine how effective the gadget is.

McDowell & Co. Ltd v CIT:¹³ In this decision, the Supreme Court ruled that tax avoidance is permissible if it complies with the law. Therefore, colourable gadgets cannot be used in tax planning, and it is not acceptable to hold the belief that one may get around paying taxes by using questionable means. Every individual who meets the requirements for paying taxes must do so honestly.

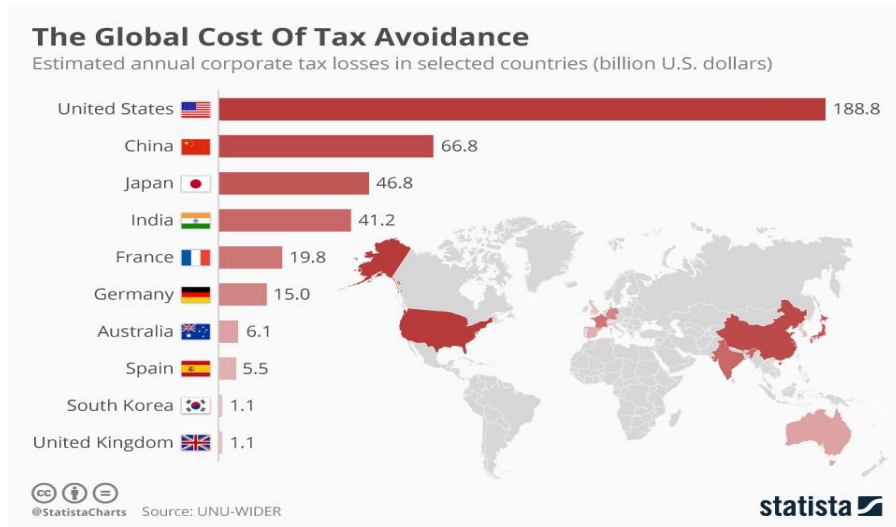
INTERNATIONAL PURVIEW

The most well-known tax injustice is multinational corporations' tax avoidance. From Italy to Indonesia, Australia to Zambia, the tax practices of technology giants like Google and Facebook or commodities companies like Glencore and Chevron have provoked public outrage and prompted regulatory solutions. Tax justice campaigners, development advocates, and academics at international organizations have focused particularly on the associated revenue losses for lower-income nations. The evidence that is now available points to the obvious conclusion that the international tax system offers MNEs chances to reduce their taxes through intra-company transfer pricing, strategic management of the placement of intangible assets, or distortion of the corporate debt structure.

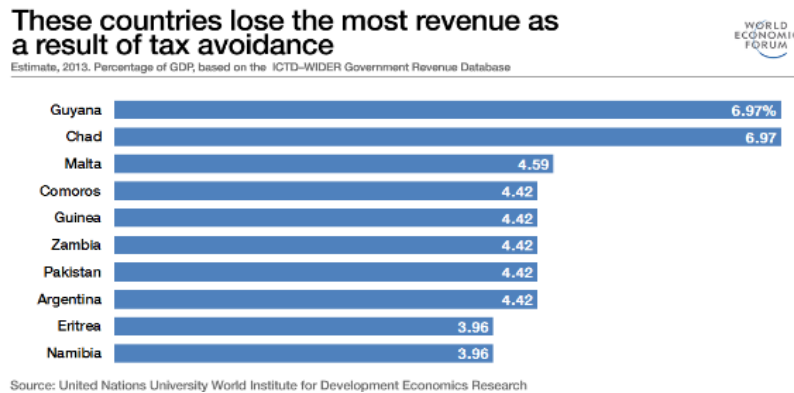
GAAR, or General Anti evasion Rules¹⁴, is the most popular strategy employed by States to combat tax evasion. According to this perspective, practically all capitalist nations have certain forms of GAAR to deal with taxpayers who seek to utilize practices and techniques for avoiding taxes.

¹³ *McDowell & Company Limited v The Commercial Tax Officer* (1986) AIR 649

¹⁴ Anuranjan Sahni, 'Understanding Basics of General Anti-Avoidance Rule (GAAR)' (*TaxGuru*, 07 May 2020) <<https://taxguru.in/income-tax/understanding-basics-general-anti-avoidance-rule-gaar.html>> accessed 19 January 2024



The statistical data¹⁵ given by Statista gives a brief idea about the losses faced in the major world economies amounting to more than a billion dollars.



The report¹⁶ emphasizes the significance of the losses when calculating GDP percentage. The severity of losses is noticeably higher in low and lower-middle-income countries than in other regions, as well as in sub-Saharan Africa, Latin America, the Caribbean, and South Asia. The graph below shows the countries that have been most negatively impacted as a proportion of GDP. In regards to total losses, it's hardly astonishing to find some of the world's largest wealth

¹⁵ Alex Cobham and Petr Janský, 'Global distribution of revenue loss from tax avoidance' (2017) UNU-WIDER 55/2017 <<https://www.wider.unu.edu/publication/global-distribution-revenue-loss-tax-avoidance>> accessed 19 January 2024

¹⁶ 'Which Countries Are Worst Affected by Tax Avoidance?' (World Economic Forum, 12 April 2017) <<https://www.weforum.org/agenda/2017/04/which-countries-are-worst-affected-by-tax-avoidance/>> accessed 19 January 2024

countries near the top. Given their financial status and economy size and power, they've suffered considerable losses because of corporate tax avoidance. Every year, The US loses an estimated 188 billion dollars, with China placed second at 66.8 billion dollars.

INTERNATIONAL CORPORATE CASES

Caterpillar Inc: Caterpillar Inc¹⁷.machinery company specializes in the field of mining and construction which is located in 'Peoria'. The company was running very successfully and recorded sales revenue of 55.7 billion dollars and the company reinvested 2 billion dollars in R&D. The committee like in the Apple case was appointed by the United States federal authorities which alleged that the Caterpillar company refrained from paying tax amounting to 2.4 billion dollars to the United States. Caterpillar established Caterpillar SARL, a subsidiary in Switzerland, in 1999 and named this affiliate as its worldwide buyer. Caterpillar negotiated a reduction in Switzerland's tax rates in the interim, ending up with an effective tax of between 4% and 6%. As per the plan, Caterpillar transferred its manufactured replacement sales to Caterpillar SARL in Switzerland, where they were recorded under Swiss tax rules without generating any U.S. income. The produced replacements were sold by the Caterpillar third-party suppliers straight to Caterpillar SARL which then distributed them to Caterpillar dealers located across the United States and the rest of the world. There were no warehouses operated by Caterpillar SARL in Switzerland or any other nation. The Swiss tax policy, as noted in the Subcommittee report, lacked economic substance and served only the objective of avoiding taxes. Finally, the Sub Committee's final report made several factual findings, the most important of which were that all of Caterpillar's operations in replacement manufacturing were directed and managed from the US and Caterpillar used contradictory valuation while shifting operations from Caterpillar to the Caterpillar SARL and then to a marketing company and that Caterpillar employed a Tax-Motivated 'Virtual Inventory' without any other business purpose but to decrease its tax load. Before this scheme 85% of taxes were paid to the USA from the total

¹⁷ Permanent Subcommittee on Investigations, *Caterpillar's Offshore Tax Strategy* (2023)

<<https://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy/>>
accessed 19 January 2024

revenue of Caterpillar Inc. and using this scheme 2.4 billion dollars in taxes were avoided by shifting 85% of its taxable revenue amounting to 8 billion dollars to Switzerland.

The Apple Inc Case:¹⁸ The technology giant Apple Inc. was accused of using many tax avoidance techniques and purposefully avoiding paying US corporate income tax by the subcommittee on investigations of the US Senate. The committee held that Apple had a subsidiary company in Ireland through which it took advantage of a cost-sharing agreement that transferred rights to developing the products in another country. This strategy resulted in the company recording 64% tax in its subsidiary company situated in Ireland and just 5% tax in the United States of America. Apple used a subsidiary in Ireland where the foreign pre-tax revenue focused on exploiting the special tax arrangement, transfer pricing, and other tax techniques to decrease its tax obligation in the U.S.

Google International:¹⁹ The tech search engine company which had numerous subsidiaries under it had executed a tax avoidance blueprint predominantly used by corporate giants which was called Double Irish with Dutch Sandwich. Google used unethical methods to avoid taxes by using companies in Ireland and the Netherlands. In this method, big businesses combine Irish and Dutch subsidiary firms to move earnings to countries with low or no taxes. Additionally, profits are sent through an Irish business at first, a Dutch firm next, and lastly another Irish corporation with headquarters in a tax haven. Many firms significantly lower the comprehensive corporate tax rates because of this specific method. Google has successfully saved billions of dollars by employing this method.

ANTI-TAX AVOIDANCE MEASURES

Given these tax avoidance strategies, it is instructive to observe how governments throughout the world respond to this issue.

¹⁸ Irene Lynch-Fannon, 'Apple Tax - The Core Issues' (2017) SSRN <<https://doi.org/10.2139/ssrn.2972788>> accessed 19 January 2024

¹⁹ "Double Irish' and 'Dutch Sandwich' Saved Google \$3.7bn in Tax in 2016" *The Irish Times* (02 January 2018) <<https://www.irishtimes.com/business/economy/double-irish-and-dutch-sandwich-saved-google-3-7bn-in-tax-in-2016-1.3343205>> accessed 19 January 2024

Legislative Solutions: Most governments appear to rely on anti-avoidance legislation enacted by their legislatures. Such laws fall into two groups, and the distinction is critical, as we will show in subsequent portions of this paper:

- Specific anti-avoidance rules [hereafter ‘SAAR’] aimed at specific tax evasion methods;
- General anti-avoidance regulations²⁰ (hereafter ‘GAAR’) are, as the name implies, a catch-all scheme for tax evasion;
- Treaties or Double Taxation Agreements [hereafter ‘DTAAs’] are also used to pursue bilateral measures.;
- This can be accomplished by inserting various clauses into them. The ‘Beneficial Ownership’ and ‘Limitation on Benefit’ sections found in many Treaties are examples of this. Specific anti-treaty shopping regulations may be included in the treaties. Articles relevant to the Exchange of Information in Treaties are also utilized to combat tax avoidance.

Judicial Solutions: Courts across the world have played an important role in inventing and improving various legal doctrines to combat avoidance strategies. When interpreting statutes, the courts may adopt a literal, or strict, perspective or a purposive one. The ideas and laws of SAAR and GAAR have been developed in large part by several courts worldwide. Two fundamental tenets of judicial anti-avoidance are as follows:

- **Substance over Form Rule (Artificiality test):** This idea, which prioritizes the essence of a transaction over its forms, is the doctrine of substance over form. Because the essence of a transaction is enduring, it takes precedence over its formal structure. This idea holds significant importance in the domain of taxation.

²⁰ Christophe J Waerzeggers and Cory Hillier, ‘Introducing a General Anti-Avoidance Rule (GAAR): Ensuring That a GAAR Achieves Its Purpose’ (*IMF*, 31 December 2016) <<https://www.imf.org/en/Publications/Tax-Law-Technical-Note/Issues/2016/12/31/Introducing-a-General-Anti-Avoidance-Rule-GAAR-Ensuring-That-a-GAAR-Achieves-Its-Purpose-43662>> accessed 19 January 2024

- **Rule of Business Purpose (motive test):** The 'Business purpose rule' is straightforward; it states that a transaction cannot be used for tax avoidance if it does not have a business purpose or commercial rationale. A firm cannot exist only to obtain a tax advantage.

Administrative Solutions: It is critical to determine if this practice has occurred and to get information on such conduct; administrative measures are a helpful tool for governments to both prevent and find out tax avoidance practices. The primary goals of administrative measures are to guarantee compliance and/or identify tax avoidance. Typically, they are completed in the following manners:

In jurisdictions without statutory GAAR, there are three possible ways to avoid using administrative powers: a) by using investigative authority when a GAAR exists; b) by using administrative authority to develop a common law avoidance case; and c) by using taxpayer notifications and rulings, which usually explain how an administration plans to apply statutory GAAR. d) By designating panels under GAAR to adjudicate GAAR matters.

CONCLUSION

Tax avoidance practices used by corporate companies indeed reduce huge tax burdens every financial year but they hurt the market which causes an imbalance and makes it an unfair market where individuals and small-scale businesses just pay their taxes completely without involving in such practices. The fact these corporate companies avoid taxes is difficult to prove because it is done legally using the provisions of law. Therefore, there are no more pertinent or important legal concerns about the validity of tax avoidance strategies. Tax avoidance plans are acknowledged by legal concepts and judicial systems to be legal. However, from an ethical perspective, there have been conflicting views on the morality of a avoidance of taxes, with some believing it to be unethical. Developing countries provide huge support for corporate companies by lowering the tax rates and in return, the companies help the country to develop. Tax avoidance is an unacceptable and unethical conduct that threatens the fairness of the taxation system. Although it is not illegal to avoid taxes by abusing the tax system, companies are nevertheless required to pay taxes due to the regulations outlined in each nation's tax laws.

Ethics should be concerned about the issue. A company's ethical guidelines for how to organize its operations and interpret tax laws are subject to a great deal of latitude while ensuring that everything it does is legal. The business model of the company itself would be set up in such a way that the companies make a profit and maximize it by reducing the tax burden and aiming majorly on avoiding taxes and procuring huge amounts of profits for its investors. States have been battling tax avoidance with a lot of effort, but they have not been particularly successful, mainly because taxpayers frequently have tax professionals ready to benefit from every new tax law that will inevitably be introduced to combat tax avoidance.