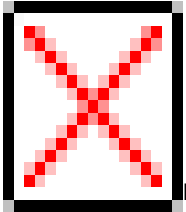


Income tax - The tale of 'creative compliance' & Tax Arbitrage!

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is not uncommon, within the boundary conditions of law as laid down, to find taxpayers' rightfully claim advantages arising on available arbitrage opportunities in the legislation itself, while at the extreme end, structured financial transactions without an underlying economic substance, use of hybrid and non-transparent vehicles, false attribution of income etc are all but components of schemes to frustrate legislation and nullify rightful tax claims. Statute itself allows tax arbitrage among income ranges, among heads of income, sometimes within the same head of income, among classes of assets and finally among various statuses that a taxpayer can legally assume. Among various slabs of income ranges, an individual, or a HUF or an AOP or a BOI, a senior citizen or a super senior citizen are taxed in range between 0 to 30%; a cooperative society or a firm or a domestic company at 30%; and a foreign company at 40% or 50% as per 1st Schedule to the Finance Act. In the statute however, option for a lower tax regime for a domestic manufacturing company at 22% under section 115BAA, for a new manufacturing domestic company at 15% under section 115BAB, a concessional tax regime for individuals and HUFs etc under section 115BAC, for resident cooperative societies at 22% under section 115BAD, and for resident cooperative societies engaged in manufacturing at 15% under section 115BAE are clear legally provided opportunities for taxpayers to minimise their tax pay-outs on fulfilment of statute laid conditions.

As much as the component of tax, a vital component of arbitrage opportunity is embedded in the element of surcharge due on amount of taxes, which as per Finance Act 2022 was in the range of 10% (for income between Rs 50 lakhs and Rs 1 cr), 15% (for income between Rs 1 cr and Rs 2 cr), 25% (for income between Rs 2 cr and Rs 5 cr) and 37% (for income between Rs 5cr to Rs 10 cr and in excess of Rs 10 cr) for every individual, HUF, AOP and BOI; 7% (for income between Rs 1 cr and Rs 10 cr) and 12%(for income in excess of Rs 10 cr) for cooperative society; 12% (for income in excess of Rs 1 cr) for every firm and local authority; 7% (for income in the range of Rs 1 cr and Rs 10 cr) and 12% (for income in excess of Rs 10 cr) for a domestic company; 2% (for income in the range between Rs 1 cr and Rs 10 cr) and 5%(for income in excess of Rs 10 cr) for a foreign company.

The third component creating an arbitrage opportunity among various statuses of taxpayers is the statute laid provisions either allowing or denying exemption to the amount of distributed profits in the hands of the ultimate beneficiary, whether a partner of a firm or a LLP or shareholder of a company. While section 10(2A) of the IT Act renders a share of a partner in the total income of a firm constituted under the Partnership Act 1932 or a LLP constituted under the Limited Liability Partnership Act, 2008 as fully exempt, omission of section 10(34) to all dividends except dividend on which tax under section 115O or section 115BBDA vide Finance Act, 2020 makes the shareholder liable to tax in respect of all dividends received by him.

Taken together, the impact of choice of status for a taxpayer in the undermentioned illustrative case (total Income Rs 5 cr; no capital gains, no options exercised under sections 115BAA, 115BAB, 115BAC) for determining the eventual tax due , if he would have filed his ITR in the status of an individual or a firm/LLP or a company for AY 23-24 would be:

Â	Individual	Firm/LLP	Company
Tax	1,48,12,500	1,50,00,000	1,50,00,000
Surcharge	37,03,125	18,00,000	10,50,000
Cess	7,40,624	6,72,000	6,42,000
Total	1,92,56,350	1,74,72,000	1,66,92,000

While tax pay-out for an individual or the firm/LLP is full and final, since the income of partner of the firm or the LLP as a share in the total income of the firm/LLP is fully exempt, tax pay-outs in the case of a company on the other hand may not be the finally determined tax pay-outs on the income of the company, as dividend it declares on its profits is fully taxable in the hands of the shareholders. Taking the illustration in the above table further if dividend of Rs 3 cr is declared out of the total income of Rs 5 cr by the company, then the individual shareholders at the highest range of tax slab would be paying by way of tax, surcharge and cess an additional amount of Rs 1,14,56,250. In all therefore, (a) the individual, (b) firm/LLP, (c) the company and its shareholders together, on identical total income of Rs 5 cr for AY 23-24 would face tax pay-outs of Rs 1,92,56,250, Rs 1,74,72,250 and Rs 2,81,48,250 respectively.

Though status under which a taxpayer would be submitting his ITR follows an inclusive definition in terms of section 2(31) of the Income Tax Act, the latter defining 'person' (obligated to be charged on his taxable income under section 4) to include an individual, HUF, company, firm, an AOP, a BOI whether incorporated or not, a local authority and every artificial juridical person', assumption of a status is subordinated to the rules and regulations of corresponding statutes and enactments delineating the conditionalities and terms of composition of those entities, and does not fall within the mere ipse dixit of the taxpayer. Before the various tests under the tax statute, for example the test of genuineness of the entity and its activities, or the test of unity of interest or the test of pursuit of a joint enterprise to produce income etc are triggered, the entity is obligated to satisfy the conditionalities governing its composition within the meaning of the statute under which it is incorporated.

Tempting as it may appear, particularly the tax arbitrage between an individual and a firm/LLP, assumption of a particular status for filing ITR while being contingent upon the legal requirements of incorporation under various statutes and enactments is equally tied up with the rules and regulations framed under those statutes and enactments. The Bar Council of India Rules under section 49(1)(ah) of the Advocates Act, 1961 provides that an advocate shall not enter into a partnership or any other arrangement for sharing remuneration with any person or legal practitioner who is not an advocate. Section 2(2) of the Chartered Accountants Act, 1949 defines a member of the Institute deemed to be in practice either individually or ***"in partnership with members of such other recognised professions as may be prescribed."***

Regulation 53B of CA Regulations 1988 allows partnership of a member of the Institute with any member of specified professional bodies established under the Institute of Company Secretaries Act, 1980, the Cost and Works Accountants Act, 1959, Advocates Act, 1961, the Institution of Engineers, the Architects Act, 1972, and the Actuaries Act, 2006. Under section 36 and 37 of the Architects Act, 1972, an architect firm can be registered by partners all of whom should be mandatorily registered by the Council of Architecture. Under section 2(2) of the Cost and Works Accountants Act, 1959, a member of the Institute shall be deemed to be practice either individually or ***"in partnership with one or more members of the Institute in practice."***

Leaving aside the above illustrations for professions, where established rules underpin the basis of incorporation of joint enterprises, whether a firm or a LLP and is solely contingent upon the professional competence and due registration under the various regulations governing those professions and effectively denying ingress to those who lack the due accreditation, there are other examples of rapidly growing but hitherto non-regulated and non-formal sectors within the professions which make constitution of a firm or a LLP without any sound economic sense or basis, regulation free and easy to manipulate. Take for example, a Bollywood actor whose income is generated solely on the basis of his brand value and professional competence forming a LLP with his parents or siblings all of whom lack any professional competence in the field which drives the actor's income. Or a social media influencer or a brand ambassador or a climate defender or a digital transformation specialist, whose income earning ability is woven primarily around his own individual competence and expertise and where formation of LLP s make no plausible economic sense except the resultant tax arbitrage.

A sizeable volume of tax related literature delves on the extent of 'creative compliance' - the space denoted between compliance and non-compliance, where legality in form is scrupulously followed alongside a complete disregard for the principle that the legality is founded on. Old examples of people bricking up their windows to avoid 'window tax' in the 17th century England is a case in point. Incorporation of LLPs with no economic substance but tax arbitrage in mind falls in that array of 'creative compliance' and bound to flourish until the scale of such 'creative compliance' affecting the tax morale and perception of equity reaches an inflexion point warranting measures to plug the loopholes through newer legislations.