DOCTRINE OF LIFTING OF CORPORATE VEIL

PERSPECTIVE IN TAXATION CASES

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"The company is at law a different person altogether from the subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or the trustee for them. Nor are subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act."

-Lord McNaughten-
Soloman v. Soloman and Co.,(1897) A.C 22 (H.L)

The law laid down in *Soloman v. Soloman and Co.*(supra) is often considered the source on the basis of which the jurisprudence of corporate personality has been written world over. However, the history of corporate-commercial litigation has witnessed situations wherein the Courts have gone beyond the corporate cloak and analyzed the working and the motives of the members or directors of the company: In doing the same, the Courts have evolved the concept of lifting or piercing the corporate veil. This article aims to bring to light the interpretational issues concerning taxation cases vis-à-vis the aforesaid doctrine and to focus on interpretation of the Indian Courts over time.

In recent times the plague of tax evasion has been so severe that the Courts have actively used the doctrine of piercing of corporate veil to probe into transactions and decide the actual entities responsible behind the facade of the company. Lately, the Hon'ble Karnataka High Court in the case of ***Richter Holding v. The Assistant Director of Income Tax***[1] used this doctrine to take the view that it may be necessary for the fact finding authority to lift the corporate veil to look into the real nature of the transaction and ascertain the virtual facts. The Hon'ble High Court further held that the Assessee, as a majority share holder, enjoys the power by way of interest and capital gains in the assets of the company and it is necessary to identify whether the transfer of shares includes indirect transfer of assets and interest in the company.

In view of the aforementioned rulings, it is eminently clear that the Indian Courts are actively pursuing this doctrine to ascertain the actual offenders and the nature of transactions behind the veil of the company. In ***Juggilal Kamlapat v. Commissioner of Income Tax, Uttar Pradesh***[2]

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[1] Writ Petition No. 7716/2011 decided on 24.03.2011

[2] AIR 1969 SC 932

(SC Full Bench), the Hon'ble Supreme Court had taken the view that the doctrine of lifting the corporate veil ought to be applied only in exceptional circumstances and not as a routine matter. However, if the intention of the Assessee is to avoid tax through a collusive device, and the real purpose was something else than what appeared on the face, then the Court may lift the veil of corporate entity to pay due regard to the economic realities behind the legal facade.

The above analysis shows that in the initial years the Courts have taken a balanced approach while using the doctrine and have time and again stated that the doctrine must be used in exceptional cases and must not be used as a tool to fasten liability on the entities behind the corporate curtain. With every passing year we see that this doctrine is being used more extensively than the previous years. This comes especially in the light of the fact that India is witnessing a corporate transition and issues pertaining to tax evasion, liquidation and subsidiary conglomerates are surfacing at an ever increasing rate. The key question that needs to be understood is to what extent should this doctrine be used; should it be used only in exceptional circumstances as it has put forth by the founding legal luminaries or should it be given a dynamic and versatile approach and be used as extensively as possible.

Reinforcing the Identity of the Company, as Distinguishable From the Director

The doctrine seems to be in vogue! As 'Scams' is the new word on the block, whether it be Satyam's Ramalinga Raju or the band wagon locked in Tihar Jail for the 2G Scam, it is the application of the niceties of the doctrine that has revealed the true culprit behind the actions of the company. The aim of the doctrine is to ensure that the players behind the corporate veil maintain the sanctity of the company's affairs and do not malign the same by injecting personal motive. Nevertheless, a situation may warrant that the legal identity of the company as a juristic person be seen in distinguishment with the identity of the person causing the tax evasion, fraud, etc.

Take the example of loss caused to a company by embezzlement, something engineered and tailored on the lines of the Satyam case, where a Managing Director (or an agent/employee) of a company, along with his confidants occupying top positions, are involved in defrauding a company of its funds and business opportunities. The Courts in this regard have opined that the loss be allowed as a deduction under the provisions of the Income Tax Act, 1961. The relevance of the example in terms of the present article is to give the doctrine of corporate veil a new facet.

In the case of ***Badridas Daga v. CIT***[3], the Hon'ble Supreme Court held that a loss caused by embezzlement is allowable as a deduction where it is shown that the loss has occurred in the course of the business and is incidental to it. Another pre-condition to be established is that the 'company' has to be unaware of the embezzlement. Further, through a plethora of decisions[4]

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[3] [1958] 34 ITR 10 (SC)

[4] See *Associated Banking Corporation of India v. CIT*, [1965] 56 ITR 1 (SC); *Lord's Dairy Farm Ltd. v. CIT*, [1955] 27 ITR 700 (Bom)

delivered after ***Badridas Daga*** (supra), additions conditions like a reasonable chance of restitution, year of allowance, etc. have been laid down.

The above view contemplates the distinguishment of the identity of the company from the person who has caused the fraud. Thus, even though the doctrine of corporate veil is applied, the separate identity of the company from its directors is not totally discarded. On the contrary, this identity is reinforced. In such cases, the knowledge of the director causing the fraud is deemed to be distinct from the knowledge of the company. The Courts will prosecute the director of the company along with his confidants and not penalize the company as a whole.

The onus in such cases therefore lies on the company to prove the absence of knowledge of the embezzlement. Though the determination of knowledge will depend on a case to case analysis, but where the company fails to do so, like in the case of ***Curtis v. J. & G. Oldfield Limited*** [5] and ***Plas-Flab Pvt. Ltd. v. Commissioner of Income Tax***[6], the loss is not allowed as a deduction. Nevertheless, the legal principle with regard to the application of the doctrine is reinforced by declaring the company as a separate juristic person and the director as another.

The facets of the doctrine of corporate veil stated hereinabove are only an illustrative list of the non-exhaustive interpretation accorded by judicial precedents. As stated, the principle is ever expansive and is applied as per the facts and circumstances of each case. However, in sum and substance, the application of the doctrine will revolve around, the facts of each case, the identity of the company and the identity of the person(s) actually involved in the misdoings. Even in taxation cases, there may be cases where the identity of a company may be disregarded to identify the real culprit, whereas on the other hand, there may be cases where the identity of the company will be reinforced to allow the separation of the knowledge of the person causing the fraud with the knowledge of the company.

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[5] [1925] 9 Tax Cas. 319

[6] [1994] 208 ITR 154