Limitation of Benefits Clause in Tax Treaties India Experience

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TABLE OF CONTENTS

Executive Summary 3
Examination of LOB Clause in India-US Tax Treaty, in the light of US Model Convention........ 5
Analysis of India-Singapore Tax Treaty Protocol on Limitation of Benefits 9
Examination of Tax Treaties that India has entered into with various countries in the recent past 12
Tax Treaties in which LOB clause was introduced after renegotiations, namely, UK, UAE and Poland 14
Supreme Court of India's ruling in the case of Azadi Bachao Andolan 16
Examination of India-Mauritius Tax Treaty and introduction of the LOB clause in the Tax Treaty 21
Analysis of conflict between GAAR and LOB 24
Way Forward 30
References 32

Executive Summary

Over a period of time the society has witnessed exploitation of intellectual creativity in evading taxes. It is for these reasons and others that countries have looked for measures to counter treaty shopping in particular.

The expertise of India in dealing with treaty shopping is in the developing stage. India adopted liberal foreign policies to participate in the global economic progress in early nineties which led to Foreign Direct Investments ("FDI") in various sectors and also investments in Indian capital market by foreign institutional investors. Prior to such globalization, India had already entered into Tax Treaties with several developed and developing countries. Even though a need arose to tackle the problem of treaty shopping in India, it is to be noted that as a part of the process of globalization and liberalization, treaty shopping is often regarded as a tax incentive to attract foreign capital or technology in many developing countries.

Traditionally, Mauritius has been the most preferred route for FDI inflows, due to the favourable clauses in the India-Mauritius tax treaty. However, after the Protocol to India-Mauritius Tax Treaty with a primary focus on bringing in source-based taxation and limiting the benefits of treaty to shell/conduit companies; it will be interesting to see if Mauritius will still remain one of the favourite routes among the investor community to invest funds into India.

The Indian Tax Administration's attempts to deny Tax Treaty benefits on the grounds of "treaty shopping" have largely been unsuccessful as witnessed in the case of Azadi Bachao Andolan[1]. The Supreme Court ("SC") in the aforementioned case held that in the absence of any specific provisions, treaty benefit could not be denied on the grounds of treaty shopping and also upheld a circular of the CBDT[2] permitting beneficial treatment under the India Mauritius treaty to an entity holding a Mauritius tax residency certificate.

Now India has comprehensive tax treaties with 88 countries and out of these, less than one-third have Article on Limitation of Benefits. However, given the recent trends, the introduction of LOB clauses in the Tax Treaties is on the rise, the most recent being in the India-Mauritius Tax Treaty.

Further, GAAR provisions were introduced in the Indian Finance Act 2012 but were postponed until Financial Year 2017-18 (w.e.f. April 1, 2017). These rules may act as a deterrent to the foreign investors and may lead to the lowering of FDI into India. The foreign investors may also have a fear of getting involved in a prolonged and expensive litigation. A tussle is foreseen in the co-existence of LOB provisions and GAAR provisions when implemented.

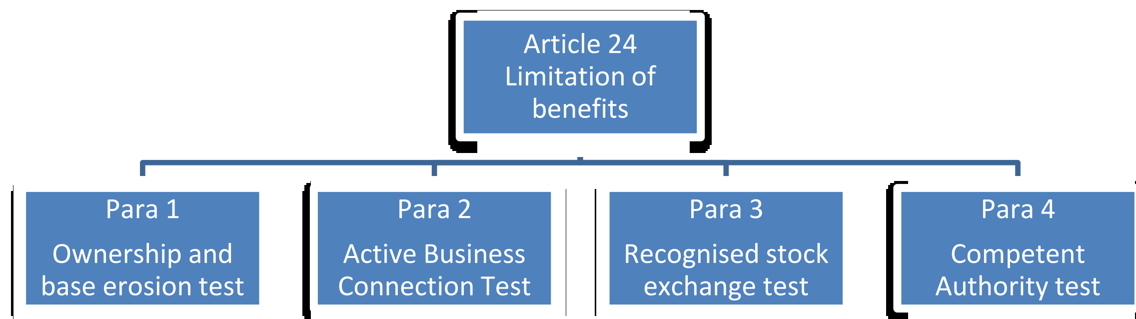
[1] [2003] 132 TAXMAN 373 (SC)
[2] Circular No. 789 dated April 13, 2000

However, for Indian anti-avoidance measures to be implemented and accepted, both tax payers and tax administration need to have an open mind-set. The anti-abuse provisions should be invoked only as an exception in deserving cases and should not be used as a tool to deny legitimate benefits to collect larger tax revenues.

Examination of LOB Clause in India-US Tax Treaty, in the light of US Model Convention

The India-US Tax Treaty came into force with effect from December 1990. Article 24-Limitation of Benefits provisions are aimed at preventing third-country residents from treaty shopping and ensure that the benefit of the treaty is available only to qualified residents.

Article 24 (LOB) of the India-US DTAA is sub-divided into four paragraphs as depicted in the below chart: -



Each of the above Paragraphs is discussed as under:-

A. Paragraph 1:- Ownership Test and Base Erosion Test

The ownership and base erosion tests for LOB Article are applicable only to non-individuals. Both the prongs i.e., the ownership test and the base erosion test have to be met in order to qualify for the benefits. However, if a person fails to qualify under this paragraph, benefits may still be granted if the person qualifies under the provisions of paragraphs 2 through 4. With regard to the ownership test:

- A Non-corporate entity would be entitled to relief in the source State only if 50% of the beneficial interest in the entity is owned, directly or indirectly, by one or more of the 'qualified owners';

- A Corporate entity would be entitled to relief in the source state only if 50% of the number of shares of each class of shares in such entity is owned directly or indirectly, by one or more of the following entities ('qualified owners').

'Qualified owners' for the purpose of this Article means:

1. Individuals, who are residents in India or USA;
2. Government of India or USA or their political sub-divisions or local authorities'
3. Other individuals subject to tax in India or USA on worldwide incomes; or
4. Citizens of USA.

The base erosion test states that an income of the particular entity should not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not "qualified entities".

'Qualified entities' for the purpose of this Article refers to –

1. Persons, who are residents in India or USA;
2. Government of India or USA or their political sub-divisions or local authorities; or
3. Citizens of USA.

The rationale for this two-part test is that since treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others, it is not enough, in order to prevent such benefits from inuring substantially to third-country residents, merely to require substantial ownership of the entity by treaty country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents[3].

Thus, the first test would be satisfied if a corporation claiming benefits is owned by another corporation which itself is owned (either directly or through additional tiers) by individual residents of a Contracting State, or other qualified owners under subparagraph 1(a)[3].

The term "substantial" has not been defined for the purposes of this Article. However deductible payments which are less than 50 percent of the relevant income is generally not considered substantial though in certain circumstances a lower percentage of income may also be treated as substantial. The term "income", as used in subparagraph (b) is to be interpreted as "gross income" under US law, as determined without regard to the residence of the income recipient. Thus, in general, the term should be understood to mean gross receipts less cost of goods sold[3].

B. Paragraph 2:- Active Business Connection Test

Paragraph 2 provides that a resident of a Contracting State deriving income from the other Contracting State will qualify for treaty benefits, regardless of its ownership (as is required under the Ownership/Base-erosion Test), if it is engaged in an active trade or business in the state of residence and the item of income for which treaty benefit is being claimed is connected with or incidental to such trade or business. A company in the business of managing investments for its own account will not be treated as carrying on an active trade or business, unless it's in the banking or insurance business. This treaty does not define the term 'active trade or business'.

This test is applied separately to each item of income of the resident, compared to the Ownership/Base-erosion Test and the Publicly Traded Company Test, where if these tests are satisfied, then all the income of the treaty resident is entitled to all the Treaty benefits.

[3] Technical Explanation Of The Convention And Protocol Between The United States Of America And The Republic Of India

Claiming benefits in accordance with the provisions of Paragraph 2 does not require the approval of the competent authority. However, the tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

For the purpose of making any determinations under Paragraph 2, the competent authorities will take into account all relevant facts and circumstances. The factual criteria which the competent authorities are expected to take into account include the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income. It is assumed that, for purposes of implementing Paragraph 2, a taxpayer will be permitted to present his case to the source State's competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the Contracting States have determined that benefits are denied. In these circumstances, it is also expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question; whichever is later, provided that the taxpayer is otherwise entitled to claim such retroactive benefits[3].

C. <u>Paragraph 3:- Recognised Stock Exchange Test</u>

Paragraph 1 does not apply, in case of a ‘company’ deriving income from source State:

- In whose principal class of shares,
- there is substantial and regular trading,
- on a recognized stock exchange

The term ‘regular trading’ has not been defined in this Article, hence this term will be defined by reference to the domestic tax laws of the Contracting States. For instance, in the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met:

- trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and;
- the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year.

The term Recognized stock exchange is defined to mean:

- For US – The NASDAQ and any Securities and Exchange Commission registered stock exchange
- For India – Government recognized stock exchange under Securities Contracts Regulation Act, 1956
- Any other stock exchange agreed by mutual agreement by competent authorities

D. Paragraph 4:- Competent Authority Test

Persons not entitled to benefit under Paragraphs 1, 2, or 3, may approach the competent authority of the source State for grant of benefits.

Competent Authority means:

- For India – Ministry of Finance (Department of Revenue)
- For US – Secretary of the Treasury

Analysis of India-Singapore Tax Treaty Protocol on Limitation of Benefits

Singapore has a territorial system of taxation according to which its residents are not subject to tax on offshore income unless it is remitted to Singapore. Thus, any offshore income earned by a person resident in Singapore shall not be taxable in Singapore unless the same is remitted or received in Singapore. In the light of the above, provisions of Article 24 were formulated to ensure that persons, individuals and enterprises alike, do not take undue advantage of the Tax Treaty in combination with the domestic tax laws.

Article 24 'Limitation of Relief' of the India-Singapore DTAA reads as follows –

> 1. *Where this Agreement provides (with or without other conditions) that income from sources in a Contracting State shall be exempt from tax, or taxed at a reduced rate in that Contracting State and under the laws in force in the other Contracting State the said income is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the exemption or reduction of tax to be allowed under this Agreement in the first-mentioned Contracting State shall apply to so much of the income as is remitted to or received in that other Contracting State.*
>
> 2. *However, this limitation does not apply to income derived by the Government of a Contracting State or any person approved by the competent authority of that State for the purpose of this paragraph. The term "Government" includes its agencies and statutory bodies.*

According to the provisions of Article 24 of the India-Singapore Tax Treaty, if the following conditions are cumulatively satisfied then the benefit of the Tax Treaty can be availed to the extent the income is actually remitted to or received in Singapore:

1. The said income is 'subject to tax' in Singapore, under its domestic tax law, by reference to the amount of such income which is remitted to or received in Singapore and not with reference to the full amount of the income earned;

2. Such income is exempt from tax or is taxed at a reduced rate in India, considering the provisions of the India-Singapore Tax Treaty; and

3. The said income is from a source in India.

On perusal of the above provisions it is evident that Article 24 specifically refers to income that is taxable with reference to remission or receipt of income in Singapore and does not state 'any income'. Therefore, it could be argued that income that are unconditionally taxable in Singapore or income that are unconditionally exempt or subject to conditions not in relation to remission are not included in the aforesaid provisions of Article 24. For example as in case of Capital Gains, Capital Gains are not subject to tax in Singapore and the same is not contingent on remission of the gains to Singapore. On this basis it could be argued that Article 24 of the Tax Treaty ought not to apply to that income. This loophole in the provisions of the India-Singapore Tax Treaty was identified.

Evaluating further, Article 13 of the India-Singapore DTAA was amended vide Notification 185/2005 dated July 18, 2005 containing the Protocol amending the India-Singapore Tax Treaty (effective as on date August 1, 2005). Paragraphs 4, 5, and 6 of Article 13 were deleted and following was introduced:

> *"4. Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 of this Article shall be taxable only in that State."*[4]

As per the provisions of the amending Protocol, any capital gains derived by a resident of Singapore other than gains from transfer/sale of immovable property, gains from transfer of movable property in relation to a Permanent Establishment ('PE') or PE as a whole, gains from alienation of ships, aircraft etc., shall be taxable only in Singapore and not in India. Therefore, any capital gains derived from sale of shares held in an Indian Company, by a person resident in Singapore, would be taxable only in Singapore and not in India. Further, as per the domestic tax laws of Singapore, Capital Gains are not taxable in Singapore, therefore the gains on transfer of such shares were in effect completely tax free. This provision led to many shell companies to be incorporated in Singapore to make gains in Indian securities totally tax-free leading to a substantial loss to the Indian exchequer.

In order to correct the effect of the existing provisions under Article 24 and to ensure that no undue advantage is derived from the aforesaid amended provisions of Article 13 of the India-Singapore Tax Treaty, Article 3 of the Protocol was introduced. Article 3 of the Protocol reads as follows:

1. *A resident of a Contracting State shall not be entitled to the benefits of Article 1 of this Protocol if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 1 of this Protocol.*

2. *A shell/conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of Article 1 of this Protocol. A shell/conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.*

3. *A resident of a Contracting State is deemed to be a shell/conduit company if its total annual expenditure*[2] *on operations in that Contracting State is less than S$200,000 or Indian Rs. 50,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 24 months from the date the gains arise.*
4. *A resident of a Contracting State is deemed not to be a shell/conduit company if—*

[4] Since India-Mauritius Tax Treaty, pursuant to the signing of the protocol on May 10, 2016, has been amended to introduce the source based taxation rule for capital gains taxation on transfer of shares. The same will have a domino effect on the capital gains taxation under the India-Singapore Tax Treaty, since the position on capital gains under the India-Singapore Tax Treaty is co-terminus with the benefits available under erstwhile provisions on capital gains contained in the Tax Treaty with Mauritius.

> a. *it is listed on a recognised stock exchange[3] of the Contracting State; or*
> b. *its total annual expenditure on operations in that Contracting State is equal to or more than S$200,000 or Indian Rs. 50,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 24 months from the date the gains arise.*
>
> *Explanation.—The cases of legal entities not having bona fide business activities shall be covered by Article 3.1 of this Protocol.*

In this connection it is pertinent to note that the aforesaid Article 3 applies specifically to Capital Gains under Article 1 of the Protocol, namely, Paragraph 4 of Article 13 of the India-Singapore Tax Treaty. Provisions of Article 3 of the Protocol are not applicable to any other streams of income.

As per this Article, any shell/conduit company cannot claim the benefit of the provisions of Article 13 of the DTAA. For the purposes of this article, a shell/conduit company is defined as 'any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in the Contracting State of which it claims to be resident.' However, if a company satisfies either of the following criteria, it shall not be taken to be a shell or conduit company:

1. the company is listed on a recognised stock exchange of the respective Contracting States; or
2. the total annual expenditure on operations in the respective Contracting State is equal to or more than $ 2,00,000 or Rs. 50,00,000 per annum for each of the two consecutive periods of 12 months preceding the date on which the gains arise.

Thus an analysis of the provisions of Article 3 of the Protocol of the India-Singapore DTAA leads to the following inferences:

1. Listed companies would be able to take advantage of the provisions as before as it need not satisfy the minimum limit on its annual operating expenditure for a consecutive period of twenty four months preceding the date of such gains.

2. The provisions relate to shell/conduit companies only and, hence, individuals and other entities which are not corporates (incorporated under any laws) are out of its purview and can continue to benefit from exemption of capital gains as per Article 13 of the DTAA. Thus, individuals and listed companies can avail of the beneficent exemption conferred by Article 13 of the DTAA as before and there is no change in the status as regards these.

3. A non-listed company would be able to take advantage of the provisions of Article 13 of the DTAA only if it has a bona fide business and this is verified when its annual expenses on its operations in its State of incorporation cross the specified limits for 2 consecutive periods of 12 months preceding the date on which the gains arise. The term 'annual expenditure' in the context of the amending protocol and the DTAA means an expenditure incurred for a period of 12 months. The period of 12 months shall be calculated referring to two blocks of 12 months immediately preceding the date on which the gains arise.

Examination of Tax Treaties that India has entered into with various countries in the recent past

This section compares the LOB clauses in the Tax Treaties entered by India in the recent past i.e., after the report addressing BEPS was issued in February 2013. For this purpose, we have taken Bhutan, Malta and Colombia into consideration.

A. India-Bhutan Tax Treaty with effect from April 1, 2015 in India

Article 27 – Limitation of Benefits

1. The provisions of this agreement shall in no case prevent a Contracting State from the application of the provisions of its domestic law and measures concerning tax avoidance or evasion, whether or not described as such.

2. A resident of a Contracting State shall not be entitled to the benefits of this Agreement if its affairs were arranged in such a manner as if it was the main purpose or one of the main purposes to take the benefits of this Agreement.

3. The case of legal entities not having bona-fide business activities shall be covered by the provisions of this Article.

B. India – Malta Tax Treaty with effect from April 1, 2015 in India

Article 27 – Limitation of Benefits

1. Nothing in this Agreement shall affect the application of the domestic provisions to prevent tax evasion.

2. Benefits of this Agreement shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Agreement that would not otherwise be available.

3. The case of legal entities not having bona fide business activities shall be covered by the provisions of this Article.

C. India – Colombia Tax Treaty with effect from April 1, 2015 in India

Article 28 – Limitation of Benefits

1. The provisions of this Agreement shall in no case prevent a Contracting State from the application of the provisions of its domestic laws and measures concerning tax avoidance or evasion, whether or not described as such.

2. An enterprise of a Contracting State shall not be entitled to the benefits of this Agreement if the main purpose or one of the main purposes of the creation of such enterprise was to obtain the benefits under this Agreement that would not otherwise be available.

3. The case of legal entities not having bona fide business activities shall be covered by the provisions of this Article.

Many of India's new Treaties, as mentioned above, contain similar LOB provisions, which take the form of 'principal purposes test'. The clause declines the Tax Treaty benefits to enterprises:

- Where the main purpose or one of the main purposes of the creation/ existence of such an enterprise is to obtain a more favourable tax position; and
- Obtaining that more favourable treatment would be contrary to the object and purpose of the relevant Tax Treaty.

Such a formulation is however to some extent subjective as it does not provide the parameters to prove the bona fide business test unlike in the case of the India-Singapore Tax Treaty.

To determine whether a main purpose or one of the main purposes for entering into transactions or arrangements is to obtain more favourable tax benefits, it should be examined from an objective point of view, based on all the relevant facts and circumstances, of whether in the absence of such tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

The above mentioned LOB provisions also contain a clause for the preservation of domestic provisions, wherein the Treaty will not prejudice each State's right to apply its domestic laws and measures concerning prevention of tax evasion/avoidance.

Further, the LOB clauses are subject to a qualification that the cases of legal entities not having bona fide business activities will also be covered by this Article.

Tax Treaties in which LOB clause was introduced after renegotiations, namely, UK, UAE and Poland

This section discusses the LOB clauses which were introduced after renegotiations, namely, UK, UAE and Poland. It is to be noted that India-Mauritius Tax Treaty has also been renegotiated and amended to bring in the LOB clause for the transition phase. The same is discussed in the subsequent sections of this research paper.

A. India-UK Tax Treaty

As per the Protocol amending the Double Taxation Agreement between UK and India, signed in London on October 30, 2012, entered into force on December 27, 2013, the limitation of benefits provision reads as follows -

> *"Article 28C – Limitation of Benefits*
>
> 1. *Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.*
>
> 2. *Where by reason of this Article a resident of a Contracting State is denied the benefits of this Convention in the other Contracting State, the competent authority of that other Contracting State shall notify the competent authority of the first-mentioned Contracting State."*

The LOB clause was inserted in the India-UK Tax Treaty in the form of principal purposes test. It proposes to deny treaty benefits if:

a) With respect to a transaction or arrangement – Main purpose or one of the main purposes of transaction or arrangement is to obtain benefits under the tax treaty;

b) With respect to creation or existence of a resident – Creation or existence of such a resident is to obtain benefits under the Tax Treaty

Further to ensure that "limitation of benefit" clause is not misapplied by tax authorities, it has been provided in the India-UK Tax Treaty that before applying this provision, if the resident of a contracting state is denied benefits in the source country, the competent authority of source country shall notify the corresponding competent authority in the country of residence of the tax payer. This provision is to safeguard the taxpayers from arbitrary application of the LOB clause by the tax officers.

B. India – UAE Tax Treaty

The LOB provisions in the India-UAE Tax Treaty were inserted after renegotiations *vide* Notification No. SO 2001(E) dated November 28, 2007. It reads as follows –

> *"Article 29 – Limitation of benefits*
>
> *An entity which is a resident of a Contracting State shall not be entitled to the benefits of this Agreement if the main purpose or one of the main purposes of the creation of such entity was to obtain the benefits of this Agreement that would not be otherwise available. The cases of legal entities not having bona fide business activities shall be covered by this Article."*

C. India – Poland Tax Treaty with effect from April 1, 2015 in India

As inserted by Notification No. 47/2014 [F.No.501/08/1979-FTD-I], dated 24-9-2014, with effect from April 1, 2015, the LOB clause inserted after renegotiations reads as follows –

> *"Article 28A – Limitation of Benefits*
>
> *Benefits of this Agreement shall not be available:*
>
> *(a) to a resident (not being an individual) of a Contracting State if the main purpose or one of the main purposes of the creation or existence of such a resident; or*
>
> *(b) with respect to any arrangement or transaction undertaken by a resident of a Contracting State, if the main purpose or one of the main purposes of the creation or existence of such an arrangement or transaction,*
>
> *is to obtain the benefits under this Agreement."*

The above mentioned LOB clauses in the India-UAE and India-Poland Tax Treaties are in the form of 'principal purposes test'. It proposes to deny the treaty benefits with respect to a transaction if the main purpose or one of the main purposes of the transaction was to obtain benefits under the respective treaties. Further, it is also provided, that the Treaty benefits may also be denied if the main purpose or one of the main purpose of creation or existence of any entity in either of the country was to obtain benefits under the respective Treaties.

However, unlike India-UK Tax Treaty, the India-UAE and India-Poland Tax Treaties do not provide safeguard against arbitrary application of the LOB Clause.

Supreme Court of India's ruling in the case of Azadi Bachao Andolan

A brief of the SC ruling in the case of Azadi Bachao Andolan[5] is provided below:

In the year 1994, vide Circular No. 682, dated March 30, 1994[6], in exercise of its powers under section 90 of the Act, the Government of India provided a clarification on Treaty provision stating that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India. Pursuant to this, a large number of Foreign Institutional Investors ("FIIs"), which were resident in Mauritius, invested large amounts of capital in shares of Indian listed companies with expectations of making profits by sale of such shares without being subjected to tax in India.

In the year 2000, the income-tax authorities issued show cause notices to some FIIs functioning in India calling upon them to show cause as to why they should not be taxed for profits and for dividends accrued to them in India. The basis on which the show cause notice was issued was that the recipients of the show cause notice were mostly "shell companies" incorporated in Mauritius, operating through Mauritius, whose main purpose was investment of funds in India. It was alleged that these companies were controlled and managed from countries other than India or Mauritius and as such they were not "residents" of Mauritius so as to derive the benefits of the DTAA.

To provide further clarification on the same, Circular No. 789 dated April 13, 2000[6] was issued, clarifying that capital gains derived by a Mauritius resident from the sale of shares of an Indian company, shall in view of Article 4 (residence) and Paragraph 4 of Article 13 of the Treaty be taxable only in Mauritius and not in India. It also stated that resident certificate issued by Mauritius would constitute sufficient evidence for accepting the status of residence (as well as beneficial ownership) for application of the Treaty provisions.

Subsequent to the issuance of Circular No 789, it was challenged in the Delhi High Court ("DHC") in a Public Interest Litigation[7] on several grounds, the important ones being:

- The circular was passed in excess of the authority vested with CBDT in relation to laying down guidelines for assessment authorities in that it invades on the quasi-judicial power of the assessment authorities that allow them lift the corporate veil in order to see whether a company is actually a resident of Mauritius or not and whether the company is paying income tax in Mauritius.
- The India-Mauritius Treaty be suitably amended or terminated such that it cannot be used by parties from non-Contracting States for their advantage.

The DHC allowed the writ petition and held inter-alia that:

[5] [2003] 132 TAXMAN 373 (SC)
[6] http://www.incometaxindia.gov.in/Pages/communications/circulars.aspx
[7] CWP 2802 of 2000 and CWP 5646 of 2000

- The circular is ultra-vires the provisions of the Income-tax Act, 1961 ("Act") in that it directs the assessment authorities to accept the certificate of residence issued by Mauritius as conclusive proof of evidence as regards status of resident and beneficial ownership. This was held as ultra-vires the powers Section 119 and Section 90 of the Act.

- Assessment authorities are entitled to lift the corporate veil in order to determine whether a company is actually a resident of Mauritius or not. Such power is quasi-judicial and any attempt by CBDT to interfere with the exercise of this quasi-judicial power is against the scheme of the Act.

- Treaty shopping is illegal and necessarily forbidden.

In 2002, a Special Leave Petition[8] was filed before the SC by the Government of India and CBDT, challenging the order passed by the DHC. The SC overturned the DHC's ruling on all the grounds and held that:

▪ ***Purpose of DTAA and Sections 4,5, 6 and 90 of the Act***

Sections 4, 5 and 6 contain the clause "are subject to the provisions of the Act", thereby enabling Section 90 of the Act to override these sections.

Relying on various case laws the Hon'ble Supreme Court held that the purpose of Section 90 of the Act is to empower the Central Government to issue notifications to implement DTAA terms and therefore if an agreement under Section 90 of the Act is inconsistent with the general principles of the Act, it will prevail over the same.

Supreme Court also held that looking into the Constitution and other references, the power to tax/grant exemptions lies with the Parliament but has been delegated to the Central Government under Section 90. Therefore, as delegates, Central Government can tax/ grant exemptions.

▪ ***Effect and validity of Circular issued under section 119 of the Act***

It was held by the Delhi High Court that Circular No.789 had an effect of interfering with the exercise of discretion of the Assessing Officer and therefore is ultra vires Section 119 of the Act. The Hon'ble Supreme Court, however held that Circular No.789 only clarified an existing position under the DTAA and since the DTAA provisions have an overriding effect over the provisions of the Income Tax Act, the impugned circular is not ultra vires Section 119 of the Act.

It was also held that, the circulars are binding even if Section 119 is not specifically referred to in such circular, since the CBDT has jurisdiction to issue such circulars.

[8] S.L.P.(C) Nos.20192-20193 of 2002 and Judgment: Union of India vs. Azadi Bachao Andolan and Ors [2003] 132 TAXMAN 373 (SC)

- ***Treaty Shopping***

The key issue pertains to treaty-shopping. Treaty shopping involves the re-routing of the funds from non-Contracting States or third-party states through one of the Contracting States to benefit from the provisions of a Tax Treaty between the two Contracting States.

The erstwhile Paragraph 4 of Article 13 of the India-Mauritius Treaty, which deals with capital gains, provides that "*Gains derived by a resident of a Contract State from the alienation of any property other than those mentioned in paragraphs (1),(2) and (3) of this article shall be taxable only in that State*." Based on this provision, CBDT in Circular No 682 dated March 30, 1994 and Circular No. 789 dated April 13, 2000 clarified that under the DTAA, a resident of Mauritius having income from alienation of shares of Indian company shall be liable to tax only in Mauritius. This was viewed as a means of treaty shopping, as many "shell companies" were set up in Mauritius with a view to take advantage of absence of capital gains tax in Mauritius.

The Hon'ble Supreme Apex Court however, following the "Duke of Westminster principle" as held by the Privy Council, concluded that companies were entitled to structure their affairs so as to limit exposure to tax as long as the arrangements were within the law.

It held that in absence of any clause in the Treaty prohibiting treaty shopping, it cannot be said that the Treaty intended for the same and if the intention was to prohibit treaty shopping, an LOB clause would have been included even in the India-Mauritius DTAA. It was observed that the Assessing Officers need not pierce the corporate veil to find out the true character of an entity since such a situation was not contemplated under the DTAA.

In the result, the Supreme Court declared that Circular No. 789, dated April 13, 2000 was valid and effective and therefore in a transaction which involved capital gains, the FII producing a residency certificate would be sufficient for it to qualify to be taxed under the provisions of the Mauritian law.

Pursuant to this landmark judgment passed by the Hon'ble Supreme Court in the case of UOI vs Azadi Bachao Andolan[5], several cases were adjudicated by heavily relying on the principle laid down in the aforementioned case. Few of such cases have been briefly dealt with below:

– ***Ardex Investment Mauritius Ltd. in re - Authority for Advance Ruling (AAR), New Delhi[9]***

The applicant, a company incorporated in Mauritius is a wholly owned subsidiary of a UK entity. The only asset held by the applicant was the equity shares of Ardex Endura (India) Pvt Ltd ("Ardex India"), a company incorporated in India. The applicant sought an advance ruling to determine its taxability in India on the proposed transfer of shares of Ardex India to another non-resident group company.

The AAR noted that even if the applicant company was incorporated for taking advantage of the Tax Treaty, it cannot be viewed as objectionable treaty-shopping, as the SC has held in the case

[9] Ardex Investments Mauritius Ltd., *In re* [A.A.R No. 866 of 2010]

of Azadi Bachao Andolan that treaty-shopping itself is not a taboo. The AAR ruled that capital gain on proposed sale of shares by the applicant to its group company is not liable to tax in view of Article 13(4) of the Indian-Mauritius Tax Treaty, and hence, the applicant can receive the sale proceeds without any tax withholding.

– ***Dynamic India Fund I, In re - Authority for Advance Ruling (AAR), New Delhi***[10]

The applicant, a tax resident of Mauritius has invested funds in India, which were pooled from various individual & institutional investors from around the world. The applicant sought an advance ruling to determine its taxability in India on the transfer of shares held in Indian companies.

The AAR observed that even though the capital gain is not taxable in Mauritius, the SC decision in the case of Azadi Bachao Andolan is binding on the authority. There was no adequate material to support the revenue’s contention that the corporate decisions of the applicant were taken from India. Accordingly, it ruled that the gain that may arise to the applicant is not chargeable to tax in India in view of Article 13(4) of the Indian-Mauritius Tax Treaty.

– ***Serco BPO Private limited v. Authority for Advance Ruling, New Delhi – High Court of Punjab and Hariyana***[11]

A share purchase agreement was entered into between Serco BPO private limited, an Indian entity (“Assessee”) and two companies namely 'Blackstone' and 'Barclay' incorporated in Mauritius. In terms of the agreement, Mauritius based companies agreed to sell their shareholding in an Indian company, namely, SKR BPO, to the assessee. The core issue pertains to whether Serco is required to deduct tax at source for any capital gains tax payable by Barclays and Blackstone on the sale of their shares to the Assessee.

The Hon’ble High Court considered that there was no evidence to authenticate that the transaction was prima facie planned for the avoidance of tax. It referred to the Union of India v. Azadi Bachao Andolan case and to Circular 789 issued by the CBDT which explicitly states that tax resident certificate issued by the Mauritius authorities constitutes sufficient evidence for accepting the status of residence as well as beneficial ownership. The High Court therefore ruled that no capital gains tax was payable by Barclays and Blackstone on the transaction and, accordingly, there was no withholding tax obligation on Serco.

– ***E Trade Mauritius Ltd, In re - Authority for Advance Ruling (AAR), New Delhi***[12]

Applicant, a company of Mauritius, is subsidiary of an American company. It purchased shares of an Indian company with funds received from its parent company by way of capital contributions and loans. Subsequently, said shares were sold to another company of Mauritius and applicant realized long term capital gains thereon in India. The applicant sought an advance ruling to determine its tax liability in India on the said transfer.

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[10] Dynamic India Fund I [AAR No. 1016 of 2010 dated 18 July, 2012]
[11] Serco BPO P (Ltd) vs Authority for Advance Rulings [2015] 60 taxmann.com 433 (Punjab and Haryana HC)
[12] E Trade Mauritius Ltd [AAR No. 826 of 2009] (2010)

The Authority for Advance Ruling dispelled all contention made by the tax authorities for denying the treaty benefit, including their allegation that the applicant was not the beneficial owner of the shares held in the Indian company. The AAR observed that Treaty benefits relating to the capital gain and dividends cannot be denied to a taxpayer holding a valid tax residency certificate issued by the Mauritian competent authorities. The AAR, following the principles of the Azadi Bachao Andolan case, held that there is no legal prohibition against treaty shopping and an underlying objective of tax avoidance is not objectionable if it is within the framework of law and not prohibited by law.

Examination of India-Mauritius Tax Treaty and introduction of the LOB clause in the Tax Treaty

Mauritius has close historical and cultural ties with India, as approximately 68 percent of the Mauritian population are Indo-Mauritians. India entered into a Double Taxation Avoidance Agreement with Mauritius with effect from April 1, 1983. The taxation of various streams of income are dealt with in Articles 2 to 22 of the India-Mauritius Tax Treaty. Gains from alienation/transfer of any property are dealt with in Article 13 of the subject Tax Treaty. The India-Mauritius Tax Treaty gained popularity due to Paragraph 4 of Article 13, however, the said paragraph is now amended to bring in the source based taxation of Capital Gains.

To appreciate the importance of LOB clause in a Tax Treaty we need to know the controversies and litigations that the Tax Treaty has witnessed. The erstwhile provision of Paragraph 4 of Article 13 of the India-Mauritius Tax Treaty has been at the epicentre of some of the large controversies in the country, the same is reproduced below:

> *"4. Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this article shall be taxable only in that State."*

According to the aforesaid Paragraph, any Capital Gains derived by a resident of Contracting State from any asset or property apart from the ones listed in Paragraphs 1 to 3 of Article 13 of the Tax Treaty shall be taxable only in the State in which the person is a 'resident'. Considering the above, any gains on sale or transfer of shares or securities of an Indian company held by a person resident in Mauritius, shall be taxable only in Mauritius. Further, as per the Mauritius Offshore Business Activities Act, 1992 certain tax incentive companies are exempt from payment of tax in Mauritius on sale of certain shares or securities. As a result any capital gains derived on sale of securities of an Indian company were rendered completely tax free. Also, Circular No. 682 dated March 30, 1994 was issued reaffirming the provisions of Paragraph 4 of Article 13 of the subject Tax Treaty.

Thanks to the exemption from payment of capital gains tax and other promising factors such as quality regulatory framework, professional labor, geographical proximity, cultural affinities, and historical ties with India, Mauritius became the most attractive conduit for investments into India. Consequently, a large number of Foreign Institutional Investor's resident in Mauritius invested in India and the investments from Mauritius increased from INR 37.5 Million in 1993 to INR 61,672.8 million in 2001. In the year 2000, the Indian income-tax authorities issued show cause notices to such FII's seeking as to why gains and dividends derived from Indian securities should not be taxable in India, with the reasoning that FII's investing in India were in fact 'shell companies' incorporated in Mauritius with the sole intention of routing investments into India. The Indian tax authorities suspected that certain other parties are taking undue advantage of this bilateral Tax Treaty i.e. treaty shopping. This action resulted in panic and hasty withdrawal of investments from Indian capital market. In order to provide reassurance to the investors Circular 789 dated April 13, 2000 was issued with the following directions:

- FII's incorporated and operating in Mauritius are residents of Mauritius as per Article 4 of the Tax Treaty;

- Wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the provisions of the Tax Treaty;

- The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

The validity of the aforesaid Circular and also the legality of treaty shopping were questioned in the case of Union of India v Azadi Bachao Andolan. As explained in the preceding paragraphs, the Hon'ble Supreme Court in the given case indicated that non-resident taxation is to be dealt with by the law and it is a pointer to the Parliament for incorporating suitable limitations provisions in the Treaty itself or in the domestic laws. In absence of any specific provisions to the contrary it would not be possible to hold that such business arrangements are illegal. Any tax payer would prefer to arrange his affairs such that he minimises his tax incidence. If the tax planning is done within the boundaries of law then the same cannot be held to be fraudulent tax evasive techniques – following the Duke of Westminster Principal.

In this context, a press release dated March 1, 2013 was issued by the Finance Ministry which provided clarification on 'Tax Residency Certificate' and further reaffirming the validity of Circular 789 of April 13, 2000. The extract of the relevant portion is as under:

> *"The Tax Residency Certificate produced by a resident of a contracting state will be accepted as evidence that he is a resident of that contracting state and the Income Tax Authorities in India will not go behind the TRC and question his resident status.*
>
> *In the case of Mauritius, circular no. 789, dated 13-4-2000 continues to be in force, pending ongoing discussions between India and Mauritius."*

Pursuant to the aforementioned ruling of the Supreme Court, the Indian authorities took it up with the Mauritius tax authorities to ensure that the bilateral tax treaties are not to be used for abusive business arrangements and that an LOB clause be inserted to check treaty abuse.

India has held multiple discussions at various occasions with Mauritius and the curtain finally came down on the long-drawn negotiations between India and Mauritius on May 10, 2016 as the two countries signed a Protocol to amend various provisions of the Tax Treaty between them, most notably being the capital gains tax benefit to Mauritian investors on sale of shares of Indian companies.

The changes on taxing capital gains are as follows:

- *Shares acquired prior to April 1, 2017*

Capital gains derived by a Mauritius resident from alienation of shares of a company resident in India shall be taxable in India from April 01, 2017. Earlier, such gains were taxable only in the country of residence, resulting in no Indian capital gains taxes on sale of securities by Mauritius based investors.

- *Transition phase*

The Protocol provides for a relaxation in respect of capital gains arising to Mauritius residents from alienation of shares between April 01, 2017 and March 31, 2019. The tax rate on any such gains shall not exceed 50% of the domestic tax rate in India. This benefit shall only be available to such Mauritius resident who satisfies the LOB test i.e. (a) not a shell/conduit company and (b) satisfies the main purpose and bonafide business test.

- *Shares acquired on or after April 1, 2017 and sold on or after April 1, 2019*

Capital gains tax benefit for sale of shares of an Indian company which are acquired on or after April 1, 2017 and sold on or after April 1, 2019 will not be available. Capital gains arising from such sale will be fully taxable as per the Indian Income Tax Act, 1961.

- *LOB Clause*

According to the LoB clause, a shell / conduit company in Mauritius will not be entitled to claim benefit of reduced tax of half the applicable rate during the period April 1, 2017 to March 1, 2019. A bright-line test which prescribes the threshold to claim this benefit has been provided i.e. the total expenditure on operations in Mauritius should not be less than Rs 2,700,000 (US $40,000) in the immediately preceding 12 months.

Analysis of conflict between GAAR and LOB

General anti-avoidance rule ("GAAR") is basically an attempt to strike down avoidance that is not understood at the time of drafting and the difficulty of having such a broad scheme has been heavily debated in various countries as when they have grappled with the thought of introducing GAAR[13].

There are multifarious issues regarding GAAR and several countries have codified GAAR in their tax statutes so as to check tax evasion by the assesses, for example, GAAR has been a part of the tax code of Canada since 1988, Australia since 1981, South Africa from 2006 and China from 2008[14].

GAAR provisions (contained in Chapter X-A) were introduced in the Indian tax law by Finance Act 2012, however the Finance Act 2015 has postponed the implementation and the provisions are to be made applicable prospectively from Financial Year 2017-18 (i.e., April 1, 2017). In a broad sense, GAAR will be applicable to arrangements/transactions which are regarded as 'impermissible avoidance arrangements' centered on the 'main purpose' test and will enable tax authorities, among other things, to re-characterize such arrangements/transactions so as to deny tax benefits.

Now the question arises as to the role of GAAR in the domestic law with regard to an LOB provision in the Tax Treaties. Whether GAAR complements the Tax Treaties or limits the application of Tax Treaties?

Vienna Convention

In this connection, the principle of "pacta sunt servanda" incorporated in Article 26[15] of the Vienna Convention on the Law of Treaties, 1969 ("VCLT" or the "Convention") suggests that in case of conflict between the provisions of Tax Treaties and those of the domestic law, the provisions of the Tax Treaties must prevail[16]. A conjoint and proper construction of Article 18[17], Article 26 and Article 31[18] of the VCLT suggests that circumstances or situations like "tax

[13] Anti-avoidance Measures by T P Ostwal and Vikram Vijayaraghavan
[14] In Pursuit of Knowledge General Anti Avoidance Rules – An Indian and International Perspective by Arnab Naskar and Shubhangi Gupta
[15] *Article 26.* "PACTA SUNT SERVANDA"-"*Every treaty in force is binding upon the parties to it and must be performed by them in good faith*".
[16] Exposure Draft on Framework of Indian GAAR by The Institute of Cost Accountants of India
[17] *Article 18.* OBLIGATION NOT TO DEFEAT THE OBJECT AND PURPOSE OF A TREATY PRIOR TO ITS ENTRY INTO FORCE – *"A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:*

(a) It has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or
(b) It has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed."

[18] *Article 31.* GENERAL RULE OF INTERPRETATION – "*1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."*

abuse" may amount to abuse of the Convention itself and therefore such abusive transactions should be disregarded while granting benefits under the Treaty[16].

Also, Article 27[19] of the Convention implies that any domestic law introduced at a later point of time cannot negate the applicability of the Treaty, as a Treaty is in the nature of a contract signed between two Contracting States and is binding in nature.

OECD Model Convention

The matter pertaining to 'improper use of Convention' is also dealt with in the OECD Commentary on the Articles of the Model Tax Convention. Relevant extracts contained in the Commentary to Article 1 are provided below:

> *"7. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion."*

Therefore, it can be observed that at no point in time are tax avoidance/ abusive transactions tolerated/ encouraged even by the Tax Treaties.

Further it also provides that:

> *"9.1 This raises two fundamental questions that are discussed in the following paragraphs:*
> *……………………………………………………………………………………………………*
> *……………………………………………………………………………………………………*
> *………………………………………………—whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions (see paragraphs 22 and following below).*
>
> *9.5 For many States, the answer to the first question is based on their answer to the second question……………………………………………………………………………………………..*
> *……………………………………………………………………………………………………*
> *……………………*
> *the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions."*

OECD therefore provided that in case of application of certain domestic anti-abuse rules to a transaction that constitutes an abuse of Tax Treaty, then there would be no conflict between the provisions of the domestic rules and the Tax Treaty.

[19] *Article 27.* INTERNAL LAW AND OBSERVANCE OF TREATIES – *"A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46."*

UN Model Convention

Even the Commentaries on the Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries also comments on the conflict between domestic law provisions and Tax Treaty provisions under the title of 'Improper Use of Treaties' and various 'Approaches to prevent the improper use of Treaties'. Relevant extract is given below:

> *"15. Generally, where the application of provisions of domestic law and the provisions of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of pacta sunt servanda which is incorporated in Article 26 of the 1969 Vienna Convention on the Law of Treaties."*

Recommendations of the Expert Committee, headed by Dr Shome

The Shome Committee's[20] recommendations on this conflict are also provided below:

> *"The Committee recommends that where the treaty itself has anti-avoidance provisions, such provisions should not be substituted by GAAR provisions under the treaty override provisions."*
>
> *"The Committee recommends that that where SAAR is applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element. Similarly where anti-avoidance rules are provided in a Tax Treaty in the form of limitation of benefit (as in the Singapore treaty) etc., the GAAR provisions shall not apply overriding the treaty. If there is evidence of violations of anti-avoidance provisions in the treaty, the treaty should be revisited, but GAAR should not override the treaty."*

Therefore, the Shome Committee recommended that in circumstances where the Tax Treaty itself contains anti-avoidance provisions, then such provisions should not be overridden by the domestic GAAR provisions by virtue of the Treaty override provisions. However, the same has not been incorporated in the Finance Act.

Conversely, the Indian tax laws currently contain an overriding provision in Section 90(2A) and 90A(2A) of the Act which states that:

> *"Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assesse even if such provisions are not beneficial to him."*

Further, Section 100 contained in Chapter X-A of the Act pertaining to the application of GAAR provisions provides that GAAR will apply in addition to, or in lieu of any other basis of taxation.

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[20] Report on General Anti Avoidance Rules (GAAR) in Income Tax Act, 1961, Expert Committee, 2012 *[the Prime Minister, in order to address the various concerns of GAAR, constituted an Expert Committee under the chairmanship of Dr Parthasarathi Shome to finalize the GAAR guidelines after consulting with various stake holders]*

Evaluation of Tax Treaties maintained by different countries

Different countries follow different approaches to resolve the conflict between Tax Treaties and the domestic anti-avoidance measures. Certain countries expressly allow the application of domestic anti avoidance rules over the Tax Treaty provisions. This is the case for example, in several Canadian, Belgian and Spanish Tax Treaties, wherein, with different nuances the wording of these treaty rules provided as follows[21]:

> *"Nothing in the agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonable be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State".*

It is observed that, some of the recent Treaties concluded by India (as detailed in preceding paragraphs under topic 'Examination of Tax Treaties that India has entered into with various in the recent past' of this Chapter), also have a similar approach of allowing domestic anti-avoidance rules to override Tax Treaty provisions. Further, the GAAR provisions introduced by the Finance Act, 2012 are also overriding in nature. It's not the case that these provisions shall get applied to every transaction seeking or sought applicability of any Tax Treaty provision rather its applicable to a transactions the "main purpose" of which is tax avoidance[16].

Considering the UK scenario in this aspect, GAAR was enacted in the UK tax legislation vide Finance Act, 2013. The relevant provision addressing the conflict between GAAR and Tax Treaties is provided below:

"212 Relationship between the GAAR and priority rules

(1) Any priority rule has effect subject to the general anti-abuse rule (despite the terms of the priority rule).

(2) A "priority rule" means a rule (however expressed) to the effect that particular provisions have effect to the exclusion of, or otherwise in priority to, anything else.

(3) Examples of priority rules are—
(a) the rule in section 464, 699 or 906 of CTA 2009 (priority of loan relationships rules, derivative contracts rules and intangible fixed assets rules for corporation tax purposes), and

(b) the rule in section 6(1) of TIOPA 2010 (effect to be given to double taxation arrangements despite anything in any enactment)."

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[21] Tax Treaty Override: A comprehensive analysis with special reference to India by Badapbiang T. Dkhar and Tanya Agarwal, National Law University, Jodhpur

Additionally, Her Majesty's Revenue and Customs ("HMRC") GAAR Guidance has also been formulated and published, with effect from January 30, 2015. It provides clarification pertaining to international tax arrangements, the relevant extracts are as provided below:

> *"B5.2.………………………………………………………………………………………… ………………………………………………………………………………………………… ………………………………………………………………The mere fact that arrangements benefit from these rules does not mean that the arrangements amount to abuse, and so the GAAR cannot be applied to them. Accordingly, many cases of the sort which generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the GAAR cannot be dealt with by the GAAR.*
>
> *B5.3 However, where there are abusive arrangements which try to exploit particular provisions in a double Tax Treaty, or the way in which such provisions interact with other provisions of UK tax law, then the GAAR can be applied to counteract the abusive arrangements"*

The above approach adopted by the UK government is consistent with the views expressed in the OECD Commentary.

BEPS Final Report

On this issue, it is also important to consider the Final BEPS Report published by OECD on October 5, 2015, wherein Action Plan 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, specifically addresses this issue.

The existing Commentary to the OECD MC provides a "guiding principle" on the circumstances under which the benefit of the Tax Treaty should be denied, which reads as follows:

> *"A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions"*

On a perusal of the above, it is clear that it has always been the intent to deny treaty benefits under circumstances wherein the main purpose of entering into a transaction/ arrangement is to secure a more favourable tax position, which then defeats the object and purpose of the Tax Treaty. The BEPS Final Report proposes to insert a "Principal Purposes Test" to address cases of improper use of the Convention, which enlivens the guiding principal.

The BEPS Final Report, proposes to revise the current OECD Commentary on Article 1 pertaining to "Improper use of the Convention". According to paragraphs 26.3 and 26.4 of the proposed revised Commentary in majority of cases there exists no conflict between the provisions of Tax Treaty and the applicability of domestic GAAR. This is because; if the provisions of domestic GAAR are formulated in line with the guiding principal it would then be similar to provisions of the PPT rule. In case of absence of PPT rule in the Tax Treaty, the

Guiding Principal would then function and hence the provisions of domestic GAAR will apply in place of the PPT rule. Considering the above, it is clear that PPT rule and domestic GAAR intend to address similar circumstances of treaty abuse and hence there exists no conflict.

Conclusion

The matter of contention being that India as a capital importing nation, relies heavily on the Foreign Direct Investment ("FDI") flowing into the country. The proposal to introduce GAAR itself created a stir among the investors and consequently an outflow of funds from India because of its possible retrospective effect, wide discretion and authority to the tax administration and its susceptibility to uncertainty and litigation. Furthermore, it also sought to override the Tax Treaties entered into by India with other sovereign nations which also had an unfavorable effect on the investors abroad.

It is clear that the main purpose of Tax Treaties is to promote international trade and commerce. However, that does not take away from the fact that the need of the hour is also to thwart tax evasion. Nonetheless, the implementation of domestic law GAAR along with Tax Treaty override may not be the solution, as it could shy away investors and lead to a lot of uncertainty. Too strict a legislation even though may help check abuse; downside of it being it could suppress the bona fine investments. One has to always walk down a balanced path.

Statistical analysis indicates that as of 2014 India ranks 85th among 175 countries in Transparency International's Corruption Perception Index (CPI) with a score of 38, having improved their position from the 94th rank with a score of 36 in 2013[22]. The CPI rank indicates the perception of the public sector corruption and India's perceived level of corruption is on the decline which could be a good sign with regard to the concern over undue harassment by tax authorities.

Legal certainty ensures a welcoming environment to the foreign investors, and, therefore, it should help foster economic growth. Accordingly, there is a need to strike a balance between enabling foreign investments but at the same time curtailing tax evasion.

[22] Transparency.org – CPI results for 2013 and 2014

Way Forward

Taxation has always been a vital subject to nations being the main source of income; it is the means through which Governments obtain the resources they need to carry out their socio-economic reforms and consequently provide a better standard of living to the population. It is understandable that the tax authorities are watching closely how companies carry out their transactions to make sure only residents of the Contracting States have access to Treaty benefits and that they do not abuse them.

In Indian context, arguably, Treaty abuse and anti-avoidance provisions and its jurisprudence are still in nascent form. However the thinking of the Government, is now inclined towards incorporating express anti-abuse rules in domestic legislation to prevent Treaty abuse. In various rulings and more importantly the Supreme Court rulings in the case of Vodafone International Holdings BV v Union of India[23] and Azadi Bachao Andolan v Union of India[5], Indian judiciary has clearly indicated that there is a loophole in the provisions of law due to which the judiciary is unable to uphold the intent of the statute. Therefore as a consequence to the aforesaid turmoil, the Indian legislature inserted General Anti-Avoidance Rules *vide* Finance Act, 2012 which was subsequently amended *vide* Finance Act, 2013. With respect to the above, it is pertinent to note that GAAR provisions are to be inserted with effect from April 1, 2017.

In this connection, prior to implementing GAAR provisions, the legislature must evaluate its impact on the Indian economy. India being a capital importing country and a developing nation must focus on stabilising the regulatory environment to ensure ease of doing business in India and giving certainty in tax laws. More importantly, it is imperative that India aligns itself with international best practices and to ensure that principles for interpretation of international law are judiciously applied. This would be necessary before the international tax regime in India can make substantial progress and inspire confidence in the international community.

As per the Final Report on Action 6 of the BEPS Action Plan, commentary to Paragraph 7 of the proposed anti-abuse Rule corresponding to GAAR identifies the need for intervention of higher authorities of tax administration to invoke GAAR. They are of the view that considering the serious nature and high impact disputes in this area, it is advisable to bring into being an administrative/approval process in order to ensure consistency in application of the Rule.

GAAR, by its very nature, has the potential of leading to significant uncertainty and litigation. It therefore, becomes critical to put in place adequate safeguards to ensure that GAAR will be applied objectively, judiciously and in a fair, consistent and uniform way. It has to be borne in mind that whereas implementing GAAR is essential to check treaty abuse, on the other hand Government must ensure that GAAR is not invoked unscrupulously. To this end, the Government must formulate clear guidelines explaining the circumstances under which GAAR can be invoked together with practical illustrations covering contentious issues, which would serve as guidance both for the taxpayers and revenue authorities.

As drafted originally, GAAR provisions sought to provide for very wide powers to the tax authorities and it was proposed to be implemented retrospectively. The original draft sought to

[23] [2012] 17taxmann.com 202 (SC)

dilute the supremacy of the Treaty over the domestic tax law and hence Treaty could also be overridden where the GAAR was invoked. Pursuant to comments received from various sections of the public, highlighting the ramifications of the wide ranging anti-avoidance and treaty override rules, the GAAR provisions were amended *vide* Finance Act 2013. The amended Rules nevertheless includes provisions in relation to treaty override, but has limited application.

At this juncture it is to be noted that for Indian anti-avoidance measures to become implementable and acceptable, both tax payers and tax administration would need to have an open mind-set and foster the atmosphere of mutual trust. The anti-abuse provisions should be invoked only as an exception in deserving cases and should not be used as a tool to deny legitimate benefits and to collect larger revenues.

The taxpayers would also need to respect the spirit of the tax laws, if they have to build confidence of the tax administration and so is the responsibility of the tax practitioners. Resorting to dubious practices by taxpayers, frivolous litigation by both, taxpayers and Revenue and invoking anti-abuse provisions on the slightest pretext may not augur well for the development of a robust international taxation system in India.

While India is keen to get its share of the tax revenues from cross-border transactions, the approach, to be adopted by the Indian authorities must be conducive and should not hamper the business environment. The key to such an approach is to ensure that they are fair and transparent and the provisions are made applicable prospectively. Any radical changes in the tax legislation will not only bring in uncertainty but also shake the faith in the tax eco-system and could lead to great disconnect and resultant litigation and tax leakage.

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