

## **Abuse of Double Taxation Avoidance Agreement by Treaty Shopping in India**

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**Abstract:** The object of research is to find out the way to prevent the abuse of double taxation avoidance agreements (DTAAs) by treaty shopping in India. Doctrinal method is adopted by the researcher, after studying the DTAA of India with other countries, approach of the judiciary while dealing with the case of misuse of DTAA by treaty shopping and mode adopted by various other countries tried to find out the means to prevent the misuse of DTAA by treaty shopping. Researcher found that by incorporating specific anti-treaty shopping article in the DTAA and through domestic legislation misuse of DTAA by treaty shopping can be checked in India.

**Keywords:** Tax avoidance, Treaty Shopping, Fiscal nullity, Limit of benefit , General Anti-avoidance rule

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### **I. INTRODUCTION**

There is a very thin dividing line between tax evasion and tax avoidance. Treaty Shopping use as means by residents of third country to take the advantage of double taxation avoidance agreements (DTAAs) of a country with another country. Residents of third country designs their business structure in such a way to take the advantage of DTAAs of a country with another country and avoid the payment of tax. The objectives of the study is to find that whether legal provisions are sufficient enough to prevent the abuse of DTAA by treaty shopping , and to find out the loopholes in the existing legal system in India, and also to find out how to fill those loopholes in India. Device of treaty shopping caused heavy loss of revenue to the government of India, study will be helpful in checking the misuse of DTAA by treaty shopping in India and prevent the loss of revenue. In order to analyze the abuse of DTAA by treaty shopping, researcher critically analyze the existing legal system of India, DTAAs of India with various other countries, legal system of other countries to prevent the misuse of DTAAs by treaty shopping and also analyze the approach of the judiciary while dealing with the case of abuse of DTAA by treaty shopping.

#### **Double Taxation Avoidance Agreement**

Income is to be tax in most of the countries according to either on residence rule or on source rule. As per source rule, the income may be subject to tax at a place where the source of such income exists. As per residence rule, the income is to tax on the basis of residential status of the person during the previous year in that country. The problem of double taxation arises if a person is subject to tax in the source country and also liable to tax on the same income in the other country on the basis of residence rule in the other country.

The Government of two countries may enter into double taxation avoidance agreements (DTAA's), so that the same income may not taxed twice. The DTAA's entered into to provide relief against double taxation on the basis of mutual agreement between two countries. Structure of DTAA would depend upon the economic relations between the two countries.[1]

Section 90 of Income Tax Act, 1961 empower the Central Government to enter into an agreement with the government of any country. It not only confine to the avoidance of double taxation and also provide for the exchange of information between the countries, which would be helpful to the government to put check on the transfer of income from one country to another and recovery of black money deposited in the other country.

#### **Interpretation of double tax avoidance agreements**

Double tax avoidance agreements(DTAAs) are international treaties. For this reason, they should be interpreted liberally[2] and in accordance with Article 31(1) of the Vienna Convention on the Law of Treaties,[3] which provides that treaties should be interpreted in the context of their object and purpose. Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties and that a literal and legalistic interpretation must be

avoided when the basic object of the treaty might be defeated or frustrated. We cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms.[4] A purposive construction is to be given to the convention looked at as a whole, rather than a literal construction.[5] Thus, the court in interpreting tax treaties apply more liberal principles than in the interpretation of domestic legislation, taking into account not only the requirement of Vienna Convention on the interpretation of treaties but also the context, object and purpose of treaty.[6]

### **Double Taxation Avoidance Agreement and Income Tax Act**

The scheme of the Income Tax Act, 1961 is to create a charge, define, classify and quantify income.[7] The DTAA does not create a charge and define income. It however classifies and quantifies in specified cases. If no tax liability is imposed under Income Tax Act, the question of resorting to the agreement would not arise. An agreement cannot impose any tax liability where the liability is not imposed by the Income Tax Act.[8]

A treaty becomes a tax statute the moment it is notified. It becomes part of the Income Tax Act, 1961, in terms of section 90 thereof. By such incorporation, it can be argued that ,it has lost its superior status and falls to be construed in its context along with the rest of the law. In case of difference between the provisions of the Income Tax Act and of DTAA under section 90, the provisions of agreement prevail over the provisions of the Act and can be enforced by the appellate authorities and the court. DTAA's are considered to be special provisions. They are the special rules. They, therefore override the Income Tax Act on the doctrine of *generalia specialibus non derogant*. [9] However, as per sub-section (2) of section 90, of Income Tax Act apply to the assessee in the event these are more beneficial to the assessee. Where, there is no specific provision in the agreement, it is the basic law i.e. Income Tax Act which will govern to taxation of income.[10]

### **Treaty Shopping:**

In order to obtain the benefit of DTAA between two countries it is necessary that the person must be the resident of one of the country. When the resident of third country take the advantage of DTAA between two countries is called Treaty Shopping. Like shopping, the resident of third country, obtain the residence of a country in order to obtain the benefit of DTAA of that country with the other country.

In *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA(2006)*[11] , it was stated that:

“ Treaty Shopping is an improper use of the tax treaty as they are contrary to the objectives of the establishment of the treaty itself. Treaty shopping may occur where taxpayers who are not residents of contracting states seek to obtain the benefits of a tax treaty by organizing a corporation or other legal entity in one of the Contracting States to serve as a conduit for income earned in the other Contracting States”.

The Authority for Advance Ruling in *E-Trade Mauritius Ltd., In re(2010)*[12] defined the expression as:

“ Treaty Shopping broadly means the use of a treaty by a person who is not resident in either of the treaty countries, usually using a conduit entity residing in one of the countries”.

### **Objectives of Treaty shopping-**

The device of treaty shopping is used to obtain the tax advantage. It is achieved because the third country has the treaty with the first which the said another country does not have or because the route is more beneficial than the direct route even though there is an appropriate tax treaty on that route also.[13] Resident of third country obtain the resident certificate of that particular country which according to their DTAA with other country in which resident of resident of third country intended to make investment imposes low or no withholding tax on royalties, interest, dividends or capital gains etc. By using the device of treaty shopping help the resident of third country to established in a jurisdiction which has a wide treaty network with other countries. The Switzerland and Holland which have favourable treaty network with other countries, therefore most of the multinational corporations commonly used as a base for international investments.

### **Effects of Treaty shopping**

While entering into DTAA the countries are free to determine its structure, terms and conditions rate of withholding tax on different kinds of income , generally the structure of DTAA depends upon the economic and political relationship . The device of treaty shopping affects the source country by loss of revenue by restricting the rate of its withholding tax in comparison the rate of tax they have to pay as per the DTAA with their country. The tools of treaty shopping assisting tax evasion to the residents of third country, which a treaty intends to prevent.

### **Judicial Interpretation of Tax Statutes and treaty shopping in India**

The tax statute was interpreted literally initially by the British court in the case of *IRC v. Duke of Westminster (1936)*[14].It was held that a tax statute to receive strict or literal interpretation. An arrangement is

to be looked at not by its economic or commercial substance but by its legal form and an arrangement is effective for tax purposes even if it has no business purpose and has been entered into to avoid tax. The Westminster doctrine gave an opportunity to the tax payer to design their tax planning within the four corners of the law to avoid the tax. Later on the British court departed from the Westminster doctrine in the case of *W.T. Ramsay v. IRC(1981)*[15], by propounding the principle of “fiscal nullity”. It means that an arrangement is to be looked at by its economic or commercial substance and not by its legal form in order to avoid the tax.

In India in the case of *CIT v. A. Raman & Co. (1968)*[16], following the Westminster doctrine held that every tax payer is entitled to arrange his affairs so that the tax attaching under the statute may be avoided. In other words the tax payer may arrange his affairs according to the provisions of the statute to avoid the tax and the revenue authorities could not take any action against the tax payer on the ground it lacks economic or commercial substance. The Supreme Court in the case of *McDowell & Co. Ltd. v. CTO(1985)*[17], observed that “we think time has come for us to depart from the Westminster principle as emphatically as the British courts have done”. The dividing line between tax evasion and tax avoidance is very thin, there is a need to give effect to substance over form while determining the tax liability under the statute.[18]

The Government of India has entered into an agreement with the Government of Mauritius for the avoidance of double taxation and for the prevention of fiscal evasion. It is applicable to a person who is a resident of one of both the contracting States viz India or Mauritius. It also provided that the capital gains arising out of the transfer of shares to a resident of Mauritius would be taxed according to the law of Mauritius. In Mauritius capital gains arising out of the transfer of shares is exempt from tax. Most of the Foreign Institutional Investors (FIIs) instead of directly investing in India, used the window of Mauritius to make the investment in India. FIIs registered a conduit company in Mauritius, without doing any business or commercial activities in Mauritius and through them they make the investment in India. The effect is that FIIs would take the advantage of DTAA between India and Mauritius and they are not liable to pay tax on capital gains arising out of the transfer of shares in India. The Central Board of Direct Tax (CBDT) in its circular number 789 dated 13<sup>th</sup> April 2000 clarified that whenever a certificate of residence issued by the Mauritius authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the agreement accordingly and also for the purpose of capital gains on sale of shares, and that the Foreign Institutional Investors (FIIs) which are resident in Mauritius would not be taxable in India on income from capital gains. The FIIs are the offshore companies registered in Mauritius for not doing any business in Mauritius.

The Delhi High Court in the case of *Shivkant Jha v. Union of India (2002)*,[19] held that the Income Tax Officer is entitled to lift the corporate veil in order to see whether a company is actually a resident of Mauritius or not and to refuse the benefit of the agreement if found not to be so on the basis of the doctrine of treaty shopping. The court also held that treaty shopping is illegal. Delhi High Court departed from the Westminster principle and followed the Ramsay principle.

But the Supreme Court of India in the case of *Union of India v. Azadi Bachao Andolan(2003)*,[20] did not agree with the decision of the Delhi High Court and observed that:

There are no disabling or disentitling conditions under the convention prohibiting the resident of a third nation from deriving benefits there under. The motives with which the residents of a third country have been incorporated in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction. The principle of piercing the veil of incorporation cannot apply. The only remedy is to make the amendment in the DTAA between India and Mauritius in order to prevent the misuse by treaty shopping. The Supreme Court of India again sticks to the Westminster doctrine which was emphatically rejected by the British Court from the “fiscal nullity” principle as propounded by the court in the Ramsay case. Many countries tolerate treaty shopping, even if it is improper and causes significant loss to the revenue because they regard it as a tax incentive to attract foreign investment in the country.

In the case of *E-Trade Mauritius Ltd. In re(2010)*[21] the applicant, a resident of Mauritius, was a subsidiary of a USA company. It received capital contribution and loans from the USA parent which were used to purchase shares in ILFS, an Indian company. On sale of the shares, the applicant earned capital gains which were chargeable to tax under the Act. However, under Article 13 (4) of the India-Mauritius tax treaty, such gains were not chargeable to tax in India. The applicant filed an application for an advance ruling on the question whether in view of the said Article 13 (4), the gains were chargeable to tax in India. The department resisted the application on the ground that though the legal ownership ostensibly vested with the applicant, the real and beneficial owner of the capital gains was the US Company which controlled the applicant and the applicant was merely a façade made use of by the US holding Company to avoid capital gains tax in India.

Rejecting the stand of the department, the Authority for Advance Rulings held that the effect of *Azadi Bachao Andolan 263 ITR 706 (SC)* is that there is no “legal taboo” against ‘treaty shopping’. Treaty shopping and the underlying objective of tax avoidance/mitigation are not equated to a colourable device. If a resident of a third country, in order to take advantage of a tax treaty sets up a conduit entity, the legal transactions entered

into by that conduit entity cannot be declared invalid. The motive behind setting up such conduit companies is not material to judge the legality or validity of the transactions. The principle that “*every man is entitled to order his affairs so that the tax is less than it otherwise would be*” is applicable though a colourable device adopted through dishonest methods can be looked into in judging a legal transaction from the tax angle. Tax avoidance is not objectionable if it is within the framework of law and not prohibited by law. However, a transaction which is ‘sham’ in the sense that “the documents are not bona fide in order to intend to be acted upon but are only used as a cloak to conceal a different transaction” stands on a different footing. For an act to be a ‘sham’, the parties thereto must have a common intention not to create the legal rights and obligations which they give the appearance of creating; On facts, as all legal formalities for purchase of the shares and their subsequent transfer had been gone through and the consideration had been received by the applicant, it was difficult to assume that the capital gain has not arisen in the hands of the applicant but had arisen in the hands of the USA parent; The fact that the USA parent provided the funds and played a role in negotiating the transaction of sale does not lead to the legal inference that the shares were in reality owned by the USA parent. To take such a view would be contrary to the ground realities of mutual business and economic relations between a holding and subsidiary company and the inter-se legal structure. The fact that the subsidiary has its own corporate personality and is a separate legal entity cannot be overlooked. The fact that the holding company exercises acts of control over its subsidiary does not in the absence of compelling reasons dilute the separate legal identity of the subsidiary. It is unrealistic to expect that a subsidiary should keep off the clutches of the holding company and conduct its business independent of any control and assistance by the parent company; Consequently, the gains made by the Applicant were not chargeable to tax in India.[22] Again the Authority for Advance Rulings did not consider treaty shopping as a colourable device to avoid the tax. That means the resident of third country may take the advantage of DTAA of India with other countries by setting up conduit companies and doing business through them in a country having a beneficial treaty provisions. The tax authorities could not take any action against the tax payer if he planned the business activities according to the provisions of the convention, it would be immaterial that they are not carrying out any commercial or economic activities. In other effect would be given to form over substance, again the court stick to the old Westminster doctrine and did not ready to depart from it.[23]

The Protocol for amendment of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains between India and Mauritius was signed by both countries on 10th May, 2016. After completion of internal procedures by both countries, the Protocol entered into force in India on 19th July, 2016 and has been notified in the Official Gazette on 11th August, 2016. The Protocol provides for source-based taxation of capital gains arising from alienation of shares acquired on or after 1st April, 2017 in a company resident in India with effect from financial year 2017-18. Simultaneously, investments made before 1st April, 2017 have been grandfathered and will not be subject to capital gains taxation in India. Where such capital gains arise during the transition period from 1st April, 2017 to 31st March, 2019, the tax rate will be limited to 50% of the domestic tax rate of India. Taxation in India at full domestic tax rate will take place from financial year 2019-20 onwards. The benefit of 50% reduction in tax rate during the transition period shall be subject to the Limitation of Benefits Article, whereby a resident of Mauritius (including a shell / conduit company) will not be entitled to benefit of 50% reduction in tax rate, if it fails the main purpose test and bonafide business test. A resident is deemed to be a shell / conduit company, if its total expenditure on operations in Mauritius is less than Rs. 2,700,000 (Mauritian Rupees 1,500,000) in the immediately preceding 12 months. The Protocol further provides for source-based taxation of interest income of banks, whereby interest arising in India to Mauritian resident banks will be subject to withholding tax in India at the rate of 7.5% in respect of debt claims or loans made after 31st March, 2017. However, interest income of Mauritian resident banks in respect of debt-claims existing on or before 31st March, 2017 shall be exempt from tax in India as per existing provisions in the Convention. The Protocol also provides for updating of the Exchange of Information Article as per the international standard, provision for assistance in collection of taxes, source-based taxation of other income, amongst other changes. The Protocol will tackle treaty abuse and round tripping of funds attributed to the India Mauritius treaty, curb revenue loss, prevent double non-taxation, streamline the flow of investment and stimulate the flow of exchange of information between the two Contracting Parties. It will improve transparency in tax matters and will help curb tax evasion and tax avoidance.[24]

### **Anti-Treaty Shopping**

The treaty shopping is checked by two ways:

1. By incorporating specific anti-treaty shopping article in the treaties( example India and Singapore treaty, India and USA treaty, India and Armenia treaty)

2. Through domestic legislation prohibiting the use of treaty for shopping. Domestic legislation ensure that the residents of third State could not take the advantage of a treaty (example Switzerland's 1962 anti-treaty shopping provisions, India's General Anti-Avoidance Rules introduced by Finance Act, 2012).

Several countries like Netherland, USA, Switzerland , UK have taken suitable steps by incorporating specific provisions in the treaties prohibiting the misuse of the treaty by a residents of third State. Article 24 of the India-US tax treaty provided that the benefit of treaty is limited to a person(other than an individual) only if- (a) more than 50 % of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of one of the contracting states, or other individuals subject to tax in either contracting state on their worldwide incomes, or citizen of US. (b) the income of such person is not used in substantial part, directly or indirectly to meet liabilities(including liabilities for interest or royalties) to persons who are not residents of one of the contracting states or citizen of US. Indo-Singapore treaty was amended by a Protocol of 2005. Article 3 of the Protocol provides that the benefits under the treaty of capital gain tax with respect to capital stock of a company would not be available to a resident of a Contracting State if its affairs were arranged with the primary purpose to take advantage, or a conduit company i.e., a 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, meaning thereby not having bona fide business activities. Article 28 of the Indo-Armenia treaty contains a limitation of benefit provision limiting the benefit under the treaty to a resident who is qualified persons in terms of the treaty.

Any abuse of the treaty may be prevented by incorporating set of anti-avoidance rules provide the domestic legislations and by giving effect judicial doctrine of "fiscal nullity", which give power to the tax authorities to bring the rigorous tax planning of form over the substance into the net of tax. In India General Anti-Avoidance Rules(GAAR) were introduced by Finance Act, 2012. It reflects the substance over form principle. A transaction can be considered void for tax purposes if there is no business reason underlying the transaction, or if a transaction is given a legal form which does not correspond to its actual character. Bona fide transaction is not covered. GAAR is not applicable if the primary purpose is other than tax avoidance, even in circumstances where tax benefit is substantial.[25] But the Government is not favour of implementing GAAR relating to international business transaction because of the fear that it may hamper the foreign investment in India. GAAR, which was originally to be implemented from 1 April, 2014, will now come into effect from 1 April, 2017 (Assessment Year 2018-19). It contains provisions allowing the government to prospectively tax overseas deals involving local assets and also prevent the misuse of DTAA in a indirect manner by the residents of third country. It means that tax benefits from the transactions and arrangements which were entered before 1April, 2017 are not covered under GAAR. The provisions of GAAR shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1<sup>st</sup> day of

April, 2017. Rule 10U of Income Tax Rules 1962 give scope to the non resident to design their arrangements and transactions to take the advantage of DTAA of India with other country.

## II. CONCLUSION

Indian judiciary followed old doctrine of Westminster and giving effect to form over the substance while interpreting tax statutes, which give opportunities to the residents of third country to take the advantage of DTAA of India with other countries in indirect manner. There is need to make amendment in the DTAA with other countries for incorporating specific provisions in the treaty which prohibit the misuse of treaty by a resident of third nation. General Anti-Avoidance Rules(GAAR) after coming into force gave power to the tax authorities to struck down the transactions lacking business or commercial substance were design to avoid the tax. The adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. However, if a case of avoidance is sufficiently addressed by Limitation of Benefits (LoB) provisions in the tax treaty, there shall not be an occasion to invoke GAAR.

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