Abuse of Tax Treaties and steps to curtail such practices

(A brief Analysis of Limitations of Benefits Provision in Tax Treaties)

By

CA. Arpith Prakash Jain
Bangalore
Email: ca.apjain@yahoo.com
1. Background and Overview

1.1 What are tax treaties/Double Tax Avoidance Agreements?
A tax treaty comprises agreements between two countries, which, by eliminating international double taxation, promote trade and investment of Capital. Many countries have agreed with other countries in treaties to mitigate the effects of double taxation (Double Tax Avoidance Agreement). Tax treaties may cover income taxes, inheritance taxes; value added taxes, or other taxes. Besides bilateral treaties, also multilateral countries are in place: Countries of the European Union (EU) have also entered into a multilateral agreement with respect to value added taxes under auspices of the EU, while a joint treaty of the Council of Europe and the OECD exists open to all nations. Tax treaties tend to reduce taxes of one treaty country for residents of the other treaty country in order to reduce double taxation of the same income.

1.2 Why Tax treaty?
Gone are the days when business was restricted within the boundary of the country, with the increase in international trade and commerce in recent years, countries in the world cannot remain independent from each other. There is a great amount of interdependence for a country with other countries. It is a well-known fact that any change in tax law significantly influences the trade and economic relations with other countries. Therefore any country would take care due care in formulating its tax laws so as to maintain its international economic interest.

In the absence of a tax treaty, income from cross-border transactions or investment would be subject to potential double taxation, first by the country where the income arises and again by the country of the recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income, between the two countries.

Tax treaties also provide other features that are vital to the competitive position of global businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring tax laws to be applied in a nondiscriminatory manner to nonresident enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit that is available exclusively under tax treaties is the mutual agreement procedure, to resolve disputes in particular cases or reach bilateral agreement on issues of interpretation or application. This bilateral administrative mechanism avoids double taxation on cross-border transactions.
1.3 Objectives of Tax Treaty

The objectives of Tax Treaty are

- The avoidance of double taxation
- Prevention of tax evasion
- Creation of certainty for tax payers
- Exchange of information

1.4 Double-tax treaty models

Double tax treaty models are developed by international organizations. They are generally used by countries as a basis for negotiations of their bilateral tax treaties. The two models most widely used as part of the continuing international efforts aimed at eliminating double taxation are:

1) the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model); and
2) the OECD Model Tax Convention on Income and on Capital (the OECD Model).

These models formed the basis for most of the several thousand tax treaties currently in force, thus providing a profound influence on international tax treaty practice.

The similarities between these two leading models reflect the importance of achieving consistency where possible. On the other hand, the divergences between them reflect the different membership and priorities of the two Organizations. The key differences relate, in particular, to the issue of to what extent a country should forego, under bilateral tax treaties, taxing rights, which would be otherwise available to it under domestic law, with a view to avoiding double taxation and encouraging investments.

In general terms, the UN Model tends to preserve a greater share of taxing rights for the source country, which is the country where investment or other activity takes place. The OECD Model, on the other hand, favors retention of a greater share of taxing rights by the residence country, which is the country of the investor or trader. Thus, the UN Model would normally allow developing countries more taxing rights on income generated by foreign investments in these countries. This has long been regarded as an issue of particular importance for developing countries in view of their development goals. Nevertheless, it is also a position that some developed countries seek in their bilateral tax treaties.

The Indian tax agreements follow the OECD/UN model, depending on whether the treaty partner is an under-developed, developing or developed country.
1.5 India’s tax treaty network

India has a large network of tax treaties for avoidance of double taxation and prevention of tax avoidance. It has comprehensive Double Taxation Avoidance Agreements (DTAA) with 84 countries\(^1\). This means that there are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation. Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to taxpayers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers irrespective of the fact that India has signed agreement with the other country.

\(^1\) Please refer http://law.incometaxindia.gov.in/DIT/intDtta.aspx
2. What are Treaty Abuse and Treaty Shopping

2.1 Treaty Abuse

The term the abuse of tax treaties is generally defined as “the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them”.

More sophisticated definition on the term of ‘abuse of tax treaties’ can be found in van Weeghel’s study\(^2\) as follows:

“[T]he use of that term is arguably narrowed down to those situations where the particular use of a tax treaty

i) has the sole intention to avoid the tax either or both of the contracting states, and

ii) defeats fundamental and enduring expectations and policy objectives shared by both states and therefore the purpose of the treaty in a broad sense.”

According to van Weeghel’s analysis, the purpose of a tax treaty is a function of

i) the primary goals to avoid double taxation and to prevent tax evasion; and

ii) the expectations and policy objectives of the treaty partners.

Thus, to determine whether a treaty abuse has taken place, one needs to examine not just the intention of the tax payer but also the purpose of the tax treaty.

This analysis is particularly important in situations where in a tax treaty also doubles up as a tool to promote bilateral trade and investments.

2.2 Treaty Shopping

The term “treaty shopping” connotes a situation in which a person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or legal person in order to obtain those treaty benefits that are not available directly\(^3\). Vogel provides a slightly different definition of “treaty shopping” by referring to a situation where ‘transactions are entered, or entities are established, in other states, solely for the purpose of enjoying the benefit of particular treaty rules existing between the state involved and a third


\(^3\)Stef van Weeghel, *supra* chapter 8, p 119.
state which otherwise would not be applicable, e.g., because the person claiming the benefit is
not a resident of one of the contracting states ... '4.

Treaty shopping, especially using a ‘conduit’, is perceived as improper use of tax treaties by
both the OECD5 and the UN6.

The OECD expressed that treaty shopping is undesirable for the following reasons:

a) Treaty benefits negotiated between two States are economically extended to
persons resident in a third State in a way unintended by the contracting States;
thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;

b) Income flowing internationally may be exempted from taxation altogether or
be subject to inadequate taxation in a way unintended by the contracting
States. This situation is unacceptable because the granting by a country of
treaty benefits is based, except in specific circumstances, on the fact that the
respective income is taxed in the other State or at least falls under the normal
taxing regime of that State;

c) The State or residence of the ultimate income beneficiary has little incentive to
enter into a treaty with the State of source, because the residents of the State
of residence can indirectly receive treaty benefits from the State of source
without the need for the State of residence to provide reciprocal benefits.

Prof. Garcia Prats suggests that “treaty shopping”— in other words, searching for a more
favorable treaty — should not be equated with treaty abuse. According to his view, the
conclusion that a situation is abusive requires and implies verification of the occurrence of an
indirect, rather than a direct, breach of a provision through a violation of its object, spirit or
purpose, something that is difficult to determine a priori7.

2.3 Categorization of Treaty Abuse

In general, schemes used for treaty shopping or treaty abuse purposes differ depending on the
situations where the taxpayer may face. The approach taken for the categorization here relies
on the observation that schemes for ‘acquiring residency of a specific country’, ‘attributing
profits or income to a specific entity’ and ‘changing the character of an income’ are the ones
frequently employed in order to achieve non-taxation (or less than single taxation) in both

5 OECD Committee on Fiscal Affairs, International Tax Avoidance and Evasion, Four Related Studies, Issues in
7Paragraph 19 of the report of Prof. Garcia Prats.
source state and residence state. Also, other treaty abuse schemes would be further explored here.

2.3.1 Acquiring Residency of a Specific Country
A person may have a residency in one or more states. In determining his residency, domestic laws of pertinent states are applied in the first place. In order to get the benefit of a tax treaty, however, he must be a resident of either or both contracting states. In other words, if a person is not a resident of any of the two contracting states, he does not deserve tax treaty benefits between the two states. Therefore, if a person wishes to enjoy the benefit of a particular tax treaty, he may establish a taxable entity that meets the requirements of residency in the country concerned and enter into transactions in order to have that entity get the tax treaty benefits. In this situation (i.e. the establishment of an intermediary entity solely to obtain the benefits of the treaty), if this conduct was clearly unintended by the contracting states, his attempt of using the treaty may be regarded as ‘abusing the treaty’.

a. Conduit Structures
Setting up conduit structures without any business rationale can be considered as an abuse of treaty. This could either be through a Direct Conduit or through a multiple holding structure wherein the intention is nothing but to claim the exemptions provided in the respective treaty partners.

b. Transfer of Residency
Transfer of residence refers to change of the residential status by an entity/person from one contracting state to another Contracting State having nil or low tax rates in order to get treaty benefit.

In case of an individual:
Who has permanent home and all his economic interests in one contracting state, in order to escape taxation of capital gain, transfer his permanent home to the other Contracting State, where such gains are subject to little tax or no tax.

In case of others:
a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly or transfers the tax residency of the legal entity to a jurisdiction which has a more favorable tax law.

In order to cope with this situation, some countries include the provision of so-called ‘departure tax’ as can be found in Article 13 (6) of the Korea-UK tax treaty.

8Smallwood Trustees v. Revenue & Customs Commissioners [2008] 10 ITLR 574 (Special Commissioners)
2.3.2 Profits or Income to a Specific Person or Entity

A taxpayer may maneuver its taxable profits or income by attributing all or part of such profits or income to a related person or entity over which he has a control. An example falling in this category could be a situation where an enterprise transfers assets such as shares, bonds or patents to permanent establishments in States that offer very favorable tax treatment. More broadly, even the conduit cases can be regarded as relating to the method of ‘attribution of profits or income to a specific person or entity (hereinafter called as ‘attribution of profits’)’ in the sense that the taxpayer concerned tries to maneuver the related transactions to attribute the relevant profits or income to the conduit.

2.3.3 Changing the Character of an Income

A taxpayer can choose a legal form of transactions with other counterparts to attain a certain economic result. This freedom in the selection of a legal form is generally respected by tax authorities unless such form deviates from its economic substance to a great degree. However, if this freedom of choice is exercised in a way that entails no tax (or less than single taxation) in both source and resident countries, it may be challenged by tax authorities of either country. Fact patterns of changing the character of an income are as below.

a. Conversion of ‘Gains from Real Property’ to ‘Gains from Shares’
b. Conversion of Dividends to Capital Gains
c. Conversion of Dividends to Interest
d. Derivative Transactions

2.3.4 Other Schemes

2.3.4.1 Shifting to Lower Tax Bracket

When a tax treaty stipulates two tier tax rates for a specific type of income, a taxpayer may attempt to maneuver the transaction as if his income fell under the scope of lower tax rate. The typical example for this is the situation where two tier rates are applicable to dividends income. For example, 5% is applied to major shareholders (e.g., shareholders with 25% or more holdings) while 15% is applied to other minor shareholders as provided in Article 10 (Dividends) of the OECD Model Convention. In this situation, a taxpayer may attempt to raise shareholding ratio in order to be subject to 5% of withholding tax rate rather than 15% of withholding tax rate.
2.3.4.2 Dilution or Splitting

Both the UN Model Convention and the OECD Model Convention have a number of numeric criteria to set a limit on the taxing right of the source state. These numeric criteria, if adopted by an actual tax treaty, provide certainty in the application of the treaty. Despite such a positive function, however, they are also vulnerable to abusive actions by some taxpayers who intend to reduce their tax burdens in the source state. The abusive actions include the dilution of value of an asset, time splitting and contract splitting as illustrated below.\(^9\)

Article 5(3) of the UN Model Convention is provided as follows:

“3. the term “permanent establishment” also encompasses:

(a) [..................................................]

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.”

Since a service PE is time-based, rather than activity-based like an agency PE, taxpayers can circumvent the time threshold for the existence of a permanent establishment through contract splitting. In other words, taxpayers, with contract splitting, can argue that the projects are disconnected from each other.

As an option for solving the above problem, a ‘disjunctive test’, designed by the Supreme Court of India in Sultan Brothers v. CIT\(^{10}\), can be recommended. The Honourable Court ruled that an Assessing Officer can enquire whether the contract could still have stood if hypothetically the contract were to be split, and the reimbursement ignored. If it can, then the sums can be subject to different tax treatment, otherwise not. According to this test, if one part stands unaffected in the absence of the other, it is a case of two separate contracts. If both parts fall in the event of failure of either of them, it is a composite, or in another term, connected contact.

The risk of contract splitting is more when both the parties to the contract are related. To deter this, certain tax treaties provide a much shorter duration as a criteria for a service PE trigger. Such a provision can be seen in the India-Singapore Treaty. Similar issues are found in some provisions on capital gains in the Model Conventions. Article 13(4) of the UN Model Convention includes 50% of value threshold for determining whether immovable property is the principal asset of an entity as a pre-condition for source taxation on the capital gains of shares of a company. Likewise, the 2005 OECD Model Convention includes a

\(^{9}\) The discussion here is based on the comment of Mr. Zhang Zhiyong, previous Chinese Expert of the Committee.

\(^{10}\) In case of Sultan Brothers v. CIT – Supreme Court \(1964\) 51 ITR 353
criterion of whether 50% of asset value of a company is derived from immovable property. If this threshold is passed, the source state has the taxing right on the capital gains of shares of a company.

This threshold, however, can be easily abused through the prospective dilution of the value of such property before the actual transfer of a share of the company concerned. Therefore, some tax authorities feel that it would be advisable to add some guidance in the relevant parts of the Commentaries to deter taxpayers from attempting to dilute the value of particular assets.\(^\text{11}\)

Another threshold issue can be raised with regard to Article 13(5) of the UN Model Convention which provides as follows:

“5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least ____ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.”

In fact, a number of actual tax treaties include the similar provision to the above paragraph with a fixed percentage (in most cases 25%), which is usually set in negotiations. The fixed participation ratio, however, can be abused by taxpayers through multiple or time-splitting transfer of shares if further detailed provisions are not provided in the above paragraph.\(^\text{12}\)

In order to reduce room for potential treaty abuse, it seems necessary either to redraft the provision or to add something in the Commentary to clarify the provision. The following is an example of redraft of Article 13(5), which may serve the above purpose.

---

\(^\text{11}\)For example, the following guidance would be useful:

“Temporary injection of cash or other assets in the company shortly before the transfer of shares would be disregarded when interpreting paragraph 4.”

\(^\text{12}\)The following case shows an example of tax avoidance using “dilution or splitting”. This case is excerpted from [case 2] of the comments on Abusive Transaction, which Mexican Expert (Mr. Armando Lara Yaffar) of the Committee has submitted:

- Company “A”, resident of country X, has a participation of 100% of the capital stock in “B”.
- “B” is a company resident of Country Y.
- “A” wants to sell all its participation in “B” to “C”.
- “C” is a company resident of Country Y.

The treaty between Country X and Country Y states that gains from the alienation of shares that represent a participation of more than 25% of the capital of a company resident in one of the States may be taxed in that State. However, the tax so charged shall not exceed 20% of the taxable gains. If “A” sells all its participation in “B”, the profits derived from such alienation would be subject to a 20% withholding tax. To avoid such taxation, “A” performs several sales not exceeding the 25% participation limit referred to in the Convention, until it reaches the desired 100%. Country X tax capital gains as ordinary income. However, income derived from the alienation of a qualified participation is exempt. The exemption participation scheme, in addition to the restriction set forth in the Convention, results an attractive strategy to those companies residents of Y that want to sell their shares without paying tax. Moreover, when the shareholders residents of X alienate enterprises in Country Y, they can do so without paying taxes in none of the Contracting States.
“Gains derived by a resident of a Contracting State from the alienation of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the other Contracting State may be taxed in that other Contracting State if the recipient of the gain, during the 12 month period preceding such alienation, had a participation, directly or indirectly, of at least _____ percent in the capital of that company or other legal person.”

Another way of reducing treaty abuse would be as laid down in Indonesia – Singapore treaty, where a Service PE is not linked one single or connected project but to the overall presence of the service provider in a Contracting State.

Article 5 – Permanent Establishment of Indonesia – Singapore treaty

Subsection 2(i)

“the furnishing of services, including consultancy services, by an enterprise through an employee or other person (other than an agent of an independent status within the meaning of paragraph 7) where the activities continue within a Contracting State for a period or periods aggregating more than 90 days within a twelve-month period.”.
3. Reaction to Tax Treaty Abuse: Measures to Counter Tax Treaty Abuse

3.1 Pool of Domestic Anti-abuse Measures
The reaction to treaty abuse would begin with an attempt to apply the domestic tax rules that were set up to prevent tax avoidance cases harmful to the fiscal interests of States. Some domestic anti-abuse measures – i.e. specific anti-abuse rules, general anti-abuse rules (GAAR), codification of “economic ownership” or “substance over form principles” – are summarized in the following.

3.1.1 Specific Anti-abuse Rules
Most countries have a collection of specific anti-abuse rules designed to deal with situations where abuse cases are likely to arise. The specific anti-abuse rules that are commonly adopted to deal with such situations usually provide, for example,

\[ i \] valuation rules to impute market value to certain transactions between related parties;
\[ ii \] rules to treat certain transactions as unrealized;
\[ iii \] rules to change the character of income from certain transactions.

Prevention of tax avoidance can be achieved in many ways. For example, the tax rules may simply prescribe the tax consequences of a defined transaction in all circumstances. Or the tax law may create a presumption which the taxpayer has to rebut if the transaction is to be permitted to operate unchanged. Likewise, tax rules may impugn the transaction only where the taxpayer entered into the transaction with a tainted purpose of achieving a particular tax outcome. Typical examples of specific anti-abuse rules are illustrated in the following.

1.1 Transfer Pricing Rules\(^{13}\)
Where a transaction takes place between related parties, the tax system will require the taxpayer to substantiate that the transaction has occurred at the arm’s length (or market) value.

1.2 Purpose-based Limits
Taxpayers may be entitled to certain tax benefits only if they have not entered into the transaction for the purpose of securing the benefit.

\(^{13}\)Some countries may consider that transfer pricing rules are not anti-abuse rules but rules for the proper determination of the tax base.
1.3 “Related to the Business” Test for Personal Expenditure

Where a taxpayer incurs expenditure that is not viewed as being exclusively for the business, that expenditure should not be eligible for tax deduction.

1.4 Re-characterization of Income in case of Conduit Arrangement

If (i) tax is reduced due to the existence of an intermediary, (ii) there is a tax avoidance plan, and (iii) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is related party, the intermediary will be deemed as a conduit. And therefore the transactions with the conduit should be disregarded.

3.1.2 General Anti-Abuse Rules (GAAR)

Several countries have adopted a general rule to deal with tax avoidance that is not adequately covered by specific rules applied in certain circumstances or by special rules which protect certain tax incentives against taxpayers’ attempts for using such incentives improperly. Mostly these rules are applied to both domestic abuse cases and treaty abuse cases. Examples of a GAAR can be found in Canada, Australia, New Zealand and Sweden, etc.

India has introduced GAAR into the Income Tax Act, 1961 through the Finance Act, 2012. To tackle aggressive tax planning / sophisticated tax structures, comprehensive GAAR is introduced to codify ‘substance’ ‘over form’ principle for tax purposes. GAAR will apply to both Indian residents as well as nonresidents. GAAR would apply only to those cases of ‘impermissible avoidance arrangements’ where the main purpose or one of the main purposes of entering into an ‘arrangement’ is to obtain a ‘tax benefit’ and such arrangement satisfies at least one of the following four tests:

- It creates rights and obligations that are normally not created between two parties dealing on arm’s length basis;
- It abuses or misuses the provisions of the ITA;
- It lacks ‘commercial substance’ or is deemed to lack commercial substance (as defined in the Bill); and
- It is carried out in a manner which is normally not employed for bona fide purposes.

14The U.S. has a provision in its tax law, which enables the IRS to issue regulations that may re-characterize transactions among multiple parties, as categorized as “financing arrangements,” into a simpler transaction between two or more parties. Another example is the Foreign Investment in Real Property tax Act adopted by the US in 1980. According to this Act, if a non-resident or a foreign corporation transfers stock in a U.S. corporation 50% or more of whose assets are made up of real property located in the U.S., capital gains arising therefrom would be deemed as effectively connected to business in the U.S. as if the gains had arisen from transfer of the real property itself.
If any arrangement is treated as impermissible avoidance arrangement, the following will be consequences of such arrangement as per Section 98 of the Income Tax Act, 1961:

**98. (1)** If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences, in relation to tax, of the arrangement, including denial of tax benefit or a benefit under a tax treaty, shall be determined, in such manner as is deemed appropriate, in the circumstances of the case, including by way of but not limited to the following, namely:

- (a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;

(e) reallocating amongst the parties to the arrangement—
   
   (i) any accrual, or receipt, of a capital or revenue nature; or
   
   (ii) any expenditure, deduction, relief or rebate;

(f) treating—

   (i) the place of residence of any party to the arrangement; or

   (ii) the situs of an asset or of a transaction,

   at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(2) For the purposes of sub-section (1),—

(i) any equity may be treated as debt or vice versa;

(ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or

(iii) any expenditure, deduction, relief or rebate may be recharacterised.
3.1.3 **Codification of “Substance-over-form” or “Economic Substance” Principle**

The substance-over-form principle is generally applied to ensure that taxpayers in the same economic position should bear the same amount of tax burden. This principle frequently functions as an anti-abuse device in that it disregards “form” designed to shift income from the genuine owner of the income to another person. The principle is recognized in most countries as one of the basic taxation principles. However, the interpretation of the term “substance” varies considerably from country to country.\(^\text{15}\) That is mainly because countries generally have different views as to the way they approach the issues of the tax avoidance and as to the degree of allowing substance to prevail over form.

3.2 **Applicability of Domestic Anti-abuse Measures to Treaty Abuse Cases**

As mentioned above, it is often the case that the national tax authorities responsible for investigating abusive cases apply the domestic anti-abuse measures described above. Such measures are usually bound by the requirements of their own tax systems, rather than by general considerations relating to the special status of the treaty rule that has been abused or evaded.

One of such anti treaty abuse measure would be Section 206AA of Income Tax Act, 1961 of India wherein a non-resident in order to get the treaty benefit is mandated to have a PAN of India else the tax will be deducted at higher rates.

Further Section 98 of Income tax relating to GAAR as discussed in para 3.1.2 above stipulates the denial of benefit of treaty if any arrangement is treated as impermissible avoidance arrangement.

3.3 **Treaty Measures for Preventing Tax Treaty Abuse**

The issues of the “abuse of tax treaties” or the “improper use of tax treaties” are currently dealt with in the Commentary on Article 1 of the UN Model Convention. Current provisions of UN Model Convention on these issues are mainly taken from the relevant parts of the 1992

---

Commentary on Article 1 of the OECD Model Convention. In 2003, however, the OECD issued extensive revisions to the Commentary on Article 1 of the Model Convention that purport to clarify the relationship between tax treaties and domestic anti-abuse rules, and the problems concerning the improper use or abuse of tax treaties. The guidance and a number of recommended provisions introduced in the above Commentaries are quite useful in understanding the meaning and background of various anti-abuse provisions included in the actual tax treaties among countries.

Various tax measures shown in the above Commentaries and actual tax treaties can be largely divided into three categories as follows:

(i) Safeguard clauses recognizing that the application of domestic anti-abuse provisions does not violate the treaty provisions,

(ii) General Anti-abuse rule, and

(iii) Specific Anti-abuse rules.

Following Sub-sections will discuss issues with regard to the above three categories one by one.

3.3.1 Safeguard Clauses recognizing that the Application of Domestic Anti-Abuse Provisions does not Violate the Treaty Provisions

The approach of this category, basically relies on the fact that tax is levied under the provisions of domestic law, not of treaties and, therefore, an abuse involving tax treaty provisions can also be characterized as an abuse of the provisions of domestic law under which tax must be paid.

3.3.2 General Anti-Abuse Rules (GAAR)

It is conceivable to include general anti-abuse provisions in tax treaties as domestic statutes of some countries do. Even though it is not easy to find an example of a GAAR from existing tax treaties, the ‘guiding principle’ introduced in paragraph 9.5 of the 2003 Commentary on Article 1 of the OECD Model Convention can be regarded as a premise based on which a GAAR of the tax treaty can be developed. The following provision is an example of a GAAR of the treaty by means of the above-mentioned ‘guiding principle’:

“The benefits of this Convention shall not be available where a main purpose for entering into transactions or arrangements is to secure a more favorable tax position

16As a consequence, they bring about the same effect as they authorize the application of domestic anti-abuse provisions without limitation.
and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.”

3.3.3 Specific Treaty Anti-abuse Rules
Specific treaty anti-abuse rules provide more certainty to taxpayers and tax administrations. This is acknowledged in paragraph 9.6 of the 2003 Commentary on Article 1 of the OECD Model Convention, which states that such rules can usefully supplement general anti-abuse provisions or judicial approaches.

The current UN Model Convention deals with specific treaty anti-abuse rules in Articles 10(2), 11(2), 11(6), 12(2) and 12(6) for the concept of “beneficial ownership” and Article 17(2) for the prevention of tax abuse using so-called ‘artiste company’. Besides, paragraphs 8 to 11 of the Commentary on Article 1 of the UN Model Convention introduce specific provisions on the criteria for identifying bona fide cases from conduit cases. Further, paragraph 4 of the Commentary on Article 24(3) of the UN Model Convention includes a provision for preventing a treaty abuse technique using the triangular cases discussed in Section 3.3.1.3. of this draft report.

In 2003, the OECD updated many parts of its Commentary relating to specific treaty abuse rules. Updates included in the Commentary on Article 1 are

(i) use of the concepts of place of effective management and permanent establishment (para. 10.1-10.2),
(ii) a comprehensive limitation-of-benefits provision (para. 20),
(iii) provisions which are aimed at particular types of income that is subject to low or no tax under a preferential tax regime (para. 21.21.2),
(iv) anti-abuse rules dealing with source taxation of specific types of income (para. 21.3-21.4),
(v) provisions which are aimed at preferential regimes introduced after the signature of the convention (para. 21.5),
(vi) provisions for ‘remittance based taxation’ (para. 26.1), and (vii) provision for ‘procedural issues of source taxation’ (para. 26.2). The 2003 update also includes the further clarification of the concept of “beneficial ownership” in Commentaries on Article 10 (para. 12-12.2), 11 (para. 9-11) and 12 (para. 4-4.2).

17 “9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy […] “
4. Limitation of Benefits clause in Treaties

Recent treaties of certain countries have contained an article intended to prevent "treaty shopping," which is the inappropriate use of tax treaties by residents of third states. These Limitation of Benefits articles deny the benefits of the tax treaty to residents that do not meet additional tests. Limitation of Benefits articles vary widely from treaty to treaty, and are often quite complex.

An LOB provision is an anti-abuse provision that sets out which residents of the Contracting States are entitled to the treaty’s benefits. The purpose of an LOB provision is to limit the ability of third country residents to obtain benefits under the said treaty. This type of use of the treaty, where third country residents establish companies in a Contracting State with the principal purpose to obtain the benefits of the treaty between the Contracting States, is commonly referred to as ‘treaty shopping’ as already discussed.

Limitations on benefits provisions generally prohibit third country residents from obtaining treaty benefits. For example, a foreign company may not be entitled to a reduced rate of withholding unless a minimum percentage of its owners are citizens or residents (or the treaty country). Limitation of Benefits clauses may be found in various United States treaties. They also can found in India-Singapore and India – UAE treaty.

If a nonresident alien individual has made an election with his or her citizen or resident spouse to be treated as a resident for income tax purposes, the nonresident may not claim to be a foreign resident to obtain the benefits of a reduced rate of, or exemption from, income tax under an income tax treaty. However, the exceptions to the saving clause in some treaties allow a resident to claim a tax treaty exemption on domestic source income.

4.1 Overview of LOB Provisions in U.S. Treaties:

With the growth of foreign companies in US, more and more such companies are seeking to expand overseas and in this regard the United States is the largest market for expansion. The United States is a high-tax jurisdiction and has one of the most complex tax systems in the world.

A foreign investor in a U.S. company will generally receive return on his investment in the form of capital gains from the divestment of the U.S. business, or the receipt of dividends, interest, royalties and other types of investment income. As the United States does not tax capital gains on the sale of capital assets, such as stock in a company (unless the company has certain U.S. real property assets), foreign investors will not generally have to concern themselves with U.S. capital gains tax issues on divestment of U.S. stock.
On the other hand, dividends, interest, and royalties and other types of investment income would be subject to a relatively high 30% U.S. withholding tax. Thus, an Indian company would have to focus on how to reduce or eliminate the 30% U.S. withholding tax on such U.S. investment income.

Finding ways to reduce or eliminate this tax cost is challenging from a U.S. perspective. The best way of lowering the 30% U.S. withholding tax is to access the benefits of a U.S. income tax treaty, which can provide reduced rates from 0% to 25%, depending on the treaty. In this regard, the U.S. has gone through many challenges over the years as a result of foreign investors creating elaborate schemes designed to lower this tax by accessing one of its many income tax treaties by treaty shopping. To counter treaty shopping, the U.S. has negotiated to have LOB provisions included in its treaties including the US-India Income Tax Treaty (‘India Treaty’). The LOB provisions limit the treaty residents who may be granted treaty benefits. Importantly, the United States has also made changes to its domestic tax laws that complement the measures taken with its income tax treaties, such as, promulgating anti-conduit regulations, and interest earning stripping rules, and through a rich history of case law and rulings have developed substance over form, economic substance and business purpose doctrines that serve to curb tax transactions that are viewed as abusive. For purposes of this discussion, we will focus only on the U.S Treaty LOB provisions.

Broadly, the LOB provisions of most U.S. income tax treaties provide that resident companies of the two Contracting States are entitled to treaty benefits (such as reduction or elimination of the 30% US withholding tax rate on investment income) only if they satisfy one of the tests under the LOB provision of the treaty in question. Although each treaty is unique, there are generally at least three objective tests found in most U.S. income tax treaties, namely :

(1) the Publicly Traded Company Test,

(2) Ownership/Base-erosion Test, and

(3) the Active Trade or Business Test.

Further, the LOB provisions will typically have a clause providing that benefits may also be granted if the competent authority of the Contracting State from which benefits are claimed determines that it is appropriate to provide treaty benefits in that case. This little used clause gives the Competent Authority of the Contracting State involved discretion to grant treaty benefits in cases where even though the treaty resident cannot satisfy any of the objective tests, it should nonetheless be granted treaty benefits.

We have seen that without the benefit of a U.S. income tax treaty, an Indian investor would be subject to a 30% U.S. withholding tax on its U.S. sourced investment income. Fortunately, the
tax treaty with India (‘India Treaty’) provides relief by reducing the 30% U.S. withholding tax rate for dividends, interest and royalties to 15%, 15% and 15/10%, respectively. There are also other U.S. income tax treaties that provide even better benefits, such as the UK Treaty, which can provide zero withholding tax on these three types of income if certain other requirements are met. The key to obtaining these reduced rates though is qualifying for treaty benefits under the respective LOB provision.

4.2 The U.S.-India Treaty LOB Provision — Article 24:
The current tax treaty with India (‘India Treaty’) entered into force in December 1990. As with its other treaties, the United States wants to ensure that under the ‘India Treaty’, only ‘qualified residents’ of either treaty country obtain treaty benefits. The paragraphs of Article 24 (LOB) that relate to companies are intended to guarantee that only Indian or U.S. resident companies that have substantial substance and strong business connections or activities in India or the United States may be entitled to use the treaty.

In this regard, Article 24, paragraph 1, provides an Ownership/Base-erosion Test that is a two-prong test, both of which must be satisfied.

Under the first prong of the test, more than 50% of each class of an Indian company’s shares must be owned, directly or indirectly, by individual residents who are subject to tax in either India or the United States, or by the government or government bodies of either Contracting State.

Under the second prong of the test, the Indian company’s gross income must not be used in ‘substantial’ part, directly or indirectly, to meet liabilities (such as interest or royalties liabilities) in the form of deductible payments to persons, other than persons who are residents, U.S. citizens or the government or government bodies of either Contracting State. The term ‘substantial’ is not defined under the treaty, however, deductible payments that are less than 50% of the company’s gross income will generally not be considered substantial. This provision is generally focused on stopping situations where third country lenders or licensors use the treaty to obtain the reduced 15% and 15/10% U.S. withholding tax rate for interest and royalty payments, respectively.

Paragraph 2 of Article 24 provides that an Indian company 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 India 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’, but as discussed below, some guidance is available in
the U.S. Treasury Technical Explanation to the ‘U.K. Treaty’ (which is the official guide to the U.K. Treaty by the United States) which provides a definition that the U.S. would likely apply consistently to all its treaties. This test is applied separately to each item of income of the Indian company, compared to the Ownership/Base-erosion Test and the Publicly Traded Company Test (discussed below), where if these tests are satisfied, then all the income of the treaty resident is entitled to all treaty benefits.

The third test under Article 24 is the Publicly Traded Company Test under paragraph 3. Under this test, a publicly traded Indian corporation can qualify for treaty benefits if its principal class of shares is substantially and regularly traded on a recognised stock exchange (e.g., the NASDAQ or New York Stock Exchange in the United States or the National Stock Exchange in India).

4.3 The U.S.-U.K. Treaty LOB Provision — Article 23:
The current tax treaty with U.K. (‘UK Treaty’) entered into force in March 2003. The UK Treaty provides zero withholding tax on dividends (0%, 5%, or 15%), interest (0%) and royalty (0%) payments if certain requirements are met. These reduced rates generally make it a very desirable treaty to access. Under its LOB provision, however, only certain categories of residents are granted these treaty benefits. The LOB provision is more extensive than the ‘India Treaty’; providing more tests under which a resident may qualify for treaty benefits, but in all cases it provides a high bar requiring that only those companies with significant substance and business activities or connections in the United Kingdom qualify.

Under paragraphs 2(c), 2(f), and 4 of Article 23, there is a Publicly Traded Company Test, an Ownership/Base-erosion Test, and an Active Trade or Business Test, respectively.

Although these LOB tests are similar to the LOB tests under the ‘India Treaty’, there are some important differences under the Publicly Traded Company Test. Under this Publicly Traded Company Test, a publicly traded company includes companies whose principal class of stock is listed on a ‘recognised stock exchange’, just like under the ‘India Treaty’. However, the recognised stock exchanges under this Publicly Traded Company Test include not only exchanges in the Contracting States, but also the stock exchanges of Ireland, Switzerland, Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto and Vienna. In addition, this Publicly Traded Company Test includes a subsection that allows certain subsidiaries of a publicly traded company to qualify for the ‘U.K. Treaty’ benefits. Under this part of the test, a company resident in one of the Contracting States that is at least 50% held by vote and value by five or fewer publicly traded companies that qualify for treaty benefits under the Publicly Trade Company Test may also qualify for ‘U.K. Treaty’ benefits (e.g., a wholly-owned U.K. subsidiary of a U.K. publicly traded company whose shares are regularly traded on the London Stock Exchange). Thus, the Publicly Traded Company
Test allows more publicly traded companies and their subsidiaries that are residents of either Contracting State to qualify for UK Treaty Benefits than those under the ‘India Treaty’.

The Active Trade or Business Test in both treaties is substantially the same. However, unlike the ‘India Treaty’, the U.S. Treasury Technical Explanation to the ‘U.K. Treaty’ does provide a definition of an active ‘trade or business’ for purposes of qualifying for treaty benefits under this test. In this regard, from a U.S. perspective, a U.K. company will be treated as carrying on an active trade or business if it carries on a ‘specific unified group of activities that constitute an independent economic enterprise carried on for profit.’ In addition, ‘a corporation will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.’ Further, any company whose function is to make or manage investments for its own account will not be treated as carrying on an active trade or business (unless it’s in the banking, insurance or securities business). The Technical Explanation makes clear that headquarters operations are considered in the business of managing investments, and therefore, the United States will not treat such companies as qualifying for treaty benefits under this test.

In addition to the tests above, the ‘U.K. Treaty’ also has Derivatives Benefits Test that is not found in the ‘India Treaty’. This test expands the types of resident companies that may qualify for ‘U.K. Treaty’ benefits. It allows a resident company that cannot satisfy one of the other tests to qualify for treaty benefits if it is owned by third country residents that meet certain requirements. Under this test, a resident company will be entitled to treaty benefits with respect to an item of income, profit or gain if: (1) at least 95% of vote and value of the company is owned, directly or indirectly, by 7 or fewer persons who are ‘equivalent beneficiaries’; and (2) less than 50% of the company’s gross income for the taxable period in which the item of income, profit or gain arises is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of deductible payments. The treaty defines an ‘equivalent beneficiary’ as a resident of an EU country or of a European Economic Area state (e.g., France, Ireland, Germany, or the Netherlands, etc.) or NAFTA states (Canada and Mexico). The equivalent beneficiary must also be entitled to all the benefits of a tax treaty between an EU country, a European Economic Area state or NAFTA state and the Contracting State from which the ‘U.K. Treaty’ benefits are claimed (the ‘Third Country Treaty’). Further, with respect to claiming treaty benefits for dividends, interest, or royalties, the equivalent beneficiary must be entitled under the Third Country Treaty to a rate of tax on the income for which benefits are being claimed that is at least as low as the rate applicable under the ‘U.K. Treaty’.

The Derivatives Benefits Test can be illustrated with the following example. A U.K. resident company owns a U.S. subsidiary and is owned 100% by a publicly traded company in France.
The U.S. subsidiary pays a dividend to the U.K. resident company. Under the ‘U.K. Treaty’, the U.K. resident company does not satisfy any of the other LOB tests. Its French parent, however, does qualify for benefits under the U.S.-France Income Tax Treaty, which provides a 5% withholding tax rate on dividend payments. Thus, the U.K. resident company will be entitled to the ‘U.K. Treaty’ benefits for dividend payments it receives from the U.S. subsidiary. The treaty rate will be limited to 5% and not the 0% the ‘U.K. Treaty’ provides, because that is the lowest rate its French parent would be granted under the U.S.-France Income Tax Treaty.
5. LOB – In treaties of India

The introduction of LOB provisions in Indian treaties is indicative of a policy to discourage treaty shopping. India renegotiated the India-Singapore Income Tax Treaty (Singapore Treaty) and the India-UAE Income Tax Treaty (UAE Treaty) through separate Protocols that add LOB provisions in each, effective in 2005 and 2008, respectively. Although it is too early to tell how extensive this shift in policy will become, for now India seems to be following a similar path taken by the United States starting in the early 1980s when it began renegotiating its income tax treaties and insisting that treaty partners agree to having LOB provisions in the renegotiated treaties.

In Azadi Bacho Aandolan\textsuperscript{18} Case, the Supreme Court of India examined in detail the doctrine of treaty shopping and it ruled that the key determining factor is whether the transaction is a sham or not. The same view was affirmed by Supreme Court in Vodafone Case\textsuperscript{19}. The same has led to a debate on the need to incorporate a LOB clause in India’s tax treaties, particularly the one with Mauritius.

The proposed General Anti Avoidance Rules in India can override a tax treaty and declare an arrangement impermissible,

5.1 A look at the LOB Provisions in the India-Singapore and India-UAE Treaties:

The India-Singapore Comprehensive Economic Co-operation Agreement (‘CECA’) was signed on June 29, 2005. As part of the CECA, Singapore and India agreed on a Protocol and the tax treaty was amended. The amendments introduced by this Protocol came into force from August 1, 2005.

The Protocol provides that capital gains arising to a resident of a Contracting State from the sale of property and shares (other than immovable property or property forming part of a permanent establishment) in the other Contracting State would be taxed only in the Contracting State where the alienator is resident.

In other words, when a Singapore company divests its interest in the Indian company, it will be exempt from Indian capital gains tax. However, to prevent third country residents from misusing the capital gains exemption by establishing a holding company in Singapore, an LOB provision was also added to the treaty.

\textsuperscript{18} Union of India v. Azadi Bachao Andolan [2003] 132 Taxman 373
\textsuperscript{19} Vodafone International Holdings B.V. vs. UOI [2012] 341 ITR 1 (SC)
The LOB provision is very limited in scope, in that it only impacts capital gains tax and not other benefits provided by the treaty. Under the LOB provision, a resident company of Singapore will not be entitled to the capital gains exemption if the primary purpose for the company’s establishment was to obtain the capital gains exemption. In addition to this test that looks at a taxpayer’s motive for its holding structure, the provision includes a second test which provides that companies (referred to as ‘shell’ companies) that have no or negligible business operations, or with no real or continuous business activities in Singapore, would not qualify for the capital gains exemption under the treaty. Under a safe harbour rule, a Singapore company would not be a shell if: (1) it was listed on recognised stock exchanges of India or Singapore, or (2) its total annual expenditure on operations in its state of residence is equal to or more than S$ 200,000 or Rs.50,00,000, as the case may be, in the 24 months immediately before the date its capital gains arise. It is not entirely clear whether the Singaporean company still has to satisfy the motive test even if it passes the safe harbour rule.

In contrast to the Singapore Treaty, the LOB provision added to the UAE Treaty is broader in scope in that it applies to all benefits under the treaty. The LOB provision provides that a company would not be entitled to treaty benefits if "the main purpose or one of the main purposes of the creation of such entity was to obtain the benefits . . ." of the treaty. Once again the intention behind the provision is to curb the use of holding companies that do not have bona fide business activities in India/UAE from being granted treaty benefits. However, unlike the Singapore Treaty, the UAE Treaty does not give any guidelines on what is required to prove that a company has sufficient business activities to obtain treaty benefits. As a result, this LOB provision will surely create unnecessary uncertainty as to the application of the treaty.

The treaty partners may need to provide some guidance on this at some point.

From a policy standpoint it appears that India will continue to request some form of an LOB provision to be added in its treaties in future treaty negotiations, including renegotiations of existing treaties (such as Cyprus and Mauritius) where it perceives misuses taking place, making tax-efficient inbound investment planning for foreign companies more challenging.

5.2 Proposed LOB clause in the India-Mauritius treaty

As on date there is no LOB clause in the India-Mauritius Tax treaty. There have been many public debates on the need for such a clause. Indian Tax authorities believe that the India-Mauritius tax treaty has been misused by foreign institutional investors by routing investments via Mauritius.
6. Conclusion

The Global economy is running through a challenging phase. In July 2012, Tax Justice Network, an independent group dedicated to high-level research, analysis and advocacy on tax regulation estimated that $21 to $32 trillion of financial assets are stashed away in tax havens. This represents up to $280 billion in lost taxes.

Tax regulators across the globe are slowly waking up to this reality and are focussing on strengthening the tax laws to prevent and regulate tax evasion.

In the domestic front, in India, the tax environment is very challenging from an inbound and outbound perspective today. Transactions which were earlier not scrutinized by the tax officers are now being taken up. The Vodafone case is a classic example wherein the sheer size of the transaction made the tax officials to examine it, even though there was no regulation or law at that point of time to tax such profits in India.

While the Indian Tax Laws did not have any specific provisions to regulate abuse, the Courts have passed judgments in this regard. The Landmark one was the 1985 Supreme Court Judgment in Supreme Court of IndiaVs Mcdowell And Co. Ltd. vs Commercial Tax Officer20 wherein the Court held that

“Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.”

India is keen to receive its share of the tax revenues available in cross-border transactions. This was evident from the recent amendments and introduction of GAAR to the 50 year old Indian Income Tax Act. To this end it seems to be heading on a policy path similarly taken by the U.S. years ago to allow only a clearly identified group of persons access to its income tax treaties and the tax benefits they provide. The use of LOB provisions in Indian income tax treaties will be something to take into consideration by foreign investors to avoid being treated as treaty shopping.

The key to such an approach is to ensure that the approach should be fair and transparent and should be prospective. Any retrospective 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.

7. References:

1. Indian Double Taxation Agreements & Tax Laws by D.P. Mittal
2. The paper prepared by the subcommittee on treaty abuses and treaty shopping (Mr. Kyung Geun Lee, Coordinator) of the Committee of Experts on International Cooperation in Tax Matters of United Nations Economic and Social Council.