Significance of ‘Preamble’ in Tax Treaties

By Sudarshan Rangan, Tax Professional

1 Introduction

- The Organization of Economic Cooperation and Development (‘OECD’) in its ambitious Base Erosion and Profit Shifting (‘BEPS’) project has adopted multilateral convention composed of the multilateral instrument (MLI) and its explanatory statements to combat tax evasion as part of Action 15 of BEPS project. The MLI allows jurisdictions to swiftly implement measures to strengthen existing tax treaties to protect governments against tax avoidance strategies that inappropriately use tax treaties to artificially shift profits to low or no-tax location. Action 15 of the BEPS Action Plan recognized the MLI, a multilateral treaty, as an innovative mechanism that would allow a more coordinated, swift and consistent approach, while retaining the flexibility required to implement these changes in a broadly consensual framework to tackle base erosion.

- While the MLI attempts to retain flexibility by providing the countries a template of limited choices to choose from, it also mandates compliance with certain ‘minimum standards’. One such minimum standard is Action 6 (aimed at preventing tax treaty abuse). This minimum standard requires (i) the inclusion of an express statement in the Preamble stating the common intention to eliminate double taxation without creating opportunities for non-taxation or reduce taxation through tax evasion or avoidance, including through treaty shopping arrangements, and (ii) at least a PPT or Principal Purpose Test rule, which is the only approach deemed to satisfy the minimum standard by its own.

Since Action 6 has mandated inclusion of preamble as a minimum standard, this essay will focus on significance of preamble in a tax treaty and relevant jurisprudence from India perspective.

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1 Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. (Source: www.oecd.org)

2 In a historical signing ceremony hosted by OECD on June 7, last, 76 countries and jurisdictions signed or expressed their intention to sign MLI
“Preamble” – Meaning and Interpretation aid.

The term Preamble according to Black Laws dictionary is “A clause at the beginning of a constitution or statute explanatory of the reasons for its enactment and the objects sought to be accomplished”. In simple terminology, A preamble is an introductory and expressionary statement in a document that explains the document's purpose and underlying philosophy. Preamble is the Act in a nutshell. It is a preparatory statement. It contains the recitals showing the reason for enactment of the Act.

As an Interpretation Aid

The preamble of a statute like the long title is a part of the Act and is an admissible aid to construction. Although not an enacting part, the preamble is expected to express the scope, object and purpose of the Act more comprehensively than the long title. Preambles can be seen to have both a contextual and a constructive role in statutory interpretation. The contextual role is where the preamble assists with confirming the ordinary meaning of the enactments, and assists with determining if there is any ambiguity in the Act. The constructive role is where the preamble is effectual in clarifying or modifying the meaning of ambiguous enactments. In the words of SIR JOHN NICHOLL: “It is to the preamble more specifically that we are to look for the reason or spirit of every statute, rehearsing this, as it ordinarily does, the evils sought to be remedied, or the doubts purported to be removed by the statute, and so evidencing, in the best and most satisfactory manner, the object or intention of the Legislature in making or passing the statute itself.”

Where there is no ambiguity, where the text is plain and clear, the preamble cannot affect the interpretation of the words — either to narrow or enlarge the meaning, but the words must be construed according to their ordinary meaning. The preamble may, no doubt, be used to solve any ambiguity or to fix the meaning of words which may have more than one meaning, but it can, however, not be used to eliminate as

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3 Brett v. Brett, (1826) 162 ER 456, pp. 458, 459
redundant or unintended, the operative provision of a statute

- *Halsbury’s Laws of England* suggests that preambles have been accepted as a part of the statute since the middle of the nineteenth century. *Maxwell on the Interpretation of Statutes* commented that there was now little to be said about preambles in interpretation, as it had been ‘authoritatively stated’ by the House of Lords in *A-G v Prince Ernest Augustus of Hanover* (‘Prince Ernest’s Case’) 5. While this case is an example of a situation where the preamble was of no assistance in construing the statute because the preamble was itself unclear, nevertheless the judges gave some definitive explanations of the role of a preamble in statutory interpretation. Included in these explanations were a number of references to the preamble’s role as part of the context. In particular, the case is authority for the proposition that an Act cannot be said to be unambiguous until it is read as a whole, including the preamble if there is one.

- Under the Indian context, the scope of preamble to the Indian constitution was under limelight and irked significant controversy. Significant questions have emerged whether preamble to the Indian constitution forms part of the constitution, for which the Indian Supreme Court in the landmark historic judgement of *Kesavanada Bharati v. State of Kerala* 6 held that:
  A. Preamble to the Constitution of India is a part of Constitution
  B. Preamble is not a source of power nor a source of limitation
  C. Preamble has a significant role to play in the interpretation of statues, also in the interpretation of provisions of the Constitution.
  D. The basic elements in the preamble cannot be amended under Article 368.

- In *District Mining Officer and others v Tata Iron & Steel Co. and another* 7, Supreme Court has observed: “It is also a cardinal principle of construction that external aids are brought in by widening the concept of context as including not only other enacting

\(^4\) State of Rajasthan v. Leela Jain, AIR 1965 SC pp.1296, 1299
\(^5\) [1957] AC 436.
\(^6\) AIR 1973 SC 1461
\(^7\) (2001) 7 SCC 358
provisions of the same statute, but its preamble, the existing state of law, other statutes in pari materia and the mischief which the statute was intended to remedy.” (para 18). In *Re Kerala Education bill*, the Supreme Court held that the policy and purpose may be deduced from the long title and the preamble

- Therefore, one may infer that based on international and Indian jurisprudence, the Preamble expresses the **scope and object** of the Act more comprehensively than the long title. The preamble may recite the grounds and the cause for making a statute and/or the evil which is sought to be remedied by it. The Preamble like the Long title can legitimately be used for construing it. However, the preamble cannot override the provisions of the Act. Only if the wording of the statute gives rise to doubts as to its proper construction (e.g. where the words or a phrase has more than one meaning and doubts arise as to which of the two meanings is intended in the Act) the preamble can and ought to be referred to arrive at the proper construction.

### 3 Preamble in Tax Treaties

- Tax treaties can be defined as an “international agreement between two sovereign states reaching an understanding as to how their residents will be taxed in respect of cross border transactions in order to avoid double taxation on the same income.

- Besides double taxation and sharing of revenue between states through negotiations and compromise, the following additional objectives are spelt out in the UN model on tax treaties:
  - To protect tax payers against double taxation
  - To encourage fee flow of international trade and capital
  - To encourage transfer of technology
  - To prevent discrimination between tax payers
  - To provide a reasonable element of legal and fiscal certainty to the investors and businessmen
  - To arrive at an acceptable basis to share tax revenues between the two states.
Further under the Income Tax Act, 1961 ('ITA'), Section 90(1) provides that Government of India may enter into DTAA with any foreign country or specified territory outside India for following objectives:
- For protection of tax payers against double taxation
- For promotion of economic mutual trade and investment
- For avoidance of double taxation of income
- For exchange or information for prevention of evasion or avoidance of income tax
- For recovery of income tax.

Therefore, many of the tax treaties entered into by India as the preamble based on the elimination of double taxation and also certain other objectives as stipulated under Section 90(1) of the ITA. Some of the tax treaties which India has entered into

<table>
<thead>
<tr>
<th>India’s Treaty</th>
<th>Preamble Clause</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Whereas the Government of the Federal Republic of Germany and the Government of the Republic of India desire to conclude an Agreement for the avoidance of double taxation with respect to taxes on income and capital and for promoting their mutual economic relations.</td>
</tr>
<tr>
<td>USA</td>
<td>The Government of the United States of America and the Government of the Republic of India, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,</td>
</tr>
<tr>
<td>Mauritius</td>
<td>The Government of the Republic of India and the Government of Mauritius, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment</td>
</tr>
<tr>
<td>UAE</td>
<td>The Government of the Republic of India and the Government of the United Arab Emirates</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>The Government of the Republic of India and the Government of Australia, desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income,</td>
</tr>
<tr>
<td><strong>desiring to promote mutual economic relations by concluding an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital have agreed as follows</strong></td>
<td></td>
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</tbody>
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- Further when it comes to International law, India follows the dualist school of law, wherein international law and municipal law as separate. According to this school of law, municipal law can apply international law only when it has been incorporated into municipal law. However, when it comes to tax treaties, India follows a monist view wherein by virtue of Section 90(2) of the ITA, provisions of tax treaty shall prevail over the provisions of the ITA which means tax treaty overrides domestic law. Hence when it comes to tax treaties in India, the municipal law is subservient to international law (whether the tax treaty should be entered by the executive or it is a legislative measure is a debate left for another day). Therefore, it is imperative that the objectives of the tax treaties entered are duly met and not being exploited.

### 4 Indian Jurisprudence relying on the preamble to tax treaty

- Some of the international tax jurisprudence from India perspective have indeed relied on preamble to the tax treaty to determine the taxability. Before we embark on the precedents, it is imperative to look at the basic principles of interpretation of a treaty.

- Tax treaty being a part of international law, interpretation must be based on certain set of principles and rules of interpretation. The Vienna Convention on the Law of Treaties (VCLT) ratified by 114 countries provides the basic rules of interpretation of

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8 India is neither a signatory nor has ratified VCLT. However, Courts in India have embraced the principles of VCLT while interpreting tax matters.
any international agreement. VCLT is a treaty concerning the international law on treaties between states. The VCLT articles are useful in understanding application and interpretation of tax treaties. The major principle under VCLT is **Article 26- Pacta sunt servanda** - Treaty in force is binding upon the parties and it is mandatory to follow the same in good faith. Therefore, on conflict in the application of tax treaties, the guiding principles laid down in the VCLT are applied to give effect to a treaty.

- Another major principle under VCLT is Article 31 which clearly states: “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose.”

  Further **Article 31(2)** of the VCLT for the purpose of interpretation of a treaty it specifies that even the preamble shall be included.

- Tax treaties being international agreements, countries have to respect them. The landmark judgement of the Supreme Court (‘SC’) in the case of **Azadi Bachao Andolan**⁹, wherein a circular issued by the Central Board of Direct Taxes, India to accept certificates of residence issued by the Mauritian Authorities as final proof of residence of taxpayer without any question was challenged. The moot question was whether India-Mauritius tax treaty was misused by virtue of a mere certificate of residence issued by the Mauritian tax authorities. For which the SC answered in negative and thereby holding that treaty shopping is valid¹⁰.

- The SC has considered the preamble of the India-Mauritius DTAA has one of the factors for its judgement. The relevant text is reproduced below:

  “Based on these observations, counsel for the appellants contended that the preamble of the Indo-Mauritius DTAC recites that it is for the "encouragement of mutual trade and investment" and this aspect of the matter cannot be lost sight of while interpreting the treaty”

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⁹ 263 ITR 706

¹⁰ Treaty shopping consists of a state which is not a party to a treaty establishing an entity within a state which is a party in order to take advantage of the provisions of that treaty. The simplest example is the establishment of a “conduit company” in a Contracting State to receive income. -Philip Baker
The Court also held that “countries need to take, and do take, a holistic view”. Further it held “A holistic view has been taken to adjudicate what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy. The loss of tax revenues could be insignificant compared to other non-tax benefit to their economy.”

The SC judgement in Azadi Bacho Andolan (supra) was an historic and landmark judgement pertaining to interpretation of tax treaties. Pursuant to Azadi Bachao Andolan, in the case of Abdul Razak Meman the AAR observed that “these recitals indicate that purpose of entering into the treaty is to promote mutual economic relations by concluding an agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital”. In the said case, the AAR held that an Individual residing in UAE is not eligible to claim the benefit of the provisions of the India-UAE tax treaty as the said Individual is not entitled to access the India-UAE tax treaty by virtue of Article 1 to 4 of the India-UAE DTAA.

Recently in the case of Indian Farmers Fertilizers Co-operative Ltd. on an issue of eligibility of tax credit under Article 25 of the India-Oman tax treaty held the following with respect to significance of preamble:

“In law, the Preamble to a Statute is a well-recognized Internal Tool of Interpretation of the Statute. In accordance with the exigencies of Public Good means a demand for the economic good of the Public. Public good corresponds to national needs and self-interest of a country. In a fiscal statue, amendment for Public Good clearly implies amendment through tax incentives to foster economic development/job growth through inflow of Foreign Capital. Thus, from the preamble itself it is clear that the exemption to dividends is a tax incentive measure aimed at fostering economic development. There is no other motive other than economic development which can be reasonably attributed to a tax incentive/exemption measure. Hence, the requirement of Article 25(4) is fulfilled in the case of the Society.”

11 276 ITR 306 (AAR) [2005]
12 Recitals referring to the preamble of the India-UAE tax treaty
13 [2017] 81 taxmann.com 288 (Delhi - Tribunal)
Further in the case of *Wipro Ltd. v. Deputy Commissioner of Income-tax*\(^{14}\) where the Karnataka High Court upheld the entitlement of foreign tax credit for a tax holiday enterprise, the Court while interpreting Section 90 of the ITA made the following reference:

“Prior to the amendment, the relief was granted in respect of income on which the income tax is paid under the Income-tax Act in the contracting country. Therefore, to get the benefit of the said provision, payment of income tax in both the countries was *sine qua non*. However, by the amendment made by the Finance Act 2003, the benefit of granting the relief was extended to even in respect of income tax chargeable under the Act. Therefore, the payment of income tax in both jurisdictions is not *sine qua non* any more for granting the relief. This provision was introduced with the **object of promoting mutual economic relations, trade and investment.** In other words, it was a policy of the Government. [Para 32]”

Even though the said judgement is directly not related to preamble of a tax treaty, it does signify that object of promoting mutual economic relations, trade and investment clause as an imperative.

Therefore, from the above, we could see that the preambles are being relied on for international tax jurisprudence and hence even though the operative portions of the tax treaties are the subject matter, nevertheless the preamble shall be relied in order to verify the entitlement or applicability of a tax treaty at the time of dispute. The apex court’s judgement in Azadi Bacho Andolan and its reliance on the preamble to India–Mauritius tax treaty has indeed opened up the significance of preamble in tax treaty. Hence it is not only avoidance of double taxation for which the tax treaties are entered, it is also for promotion of mutual economic trade and relations.

5 **Preamble in Multilateral Instruments – Action 15 – BEPS Project**

Having seen the significance of preamble in the earlier paragraphs, it can be inferred that preamble can also be used advantageously by those who are looking to exploit the tax benefits provided in certain country viz. Mauritius. Even though the objective of tax treaty is to avoid double taxation, due to certain efficient planning many tax

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\(^{14}\) [2015] 62 taxmann.com 26 (Karnataka]
payers end up having double non-taxation. Many tax havens are being used by corporates to achieve the objective of double non-taxation. Hence in order to curb this practice, the BEPS project will seek to eradicate double non-taxation and end treaty abuse.

- Action 15-MLI as mentioned in the introduction paragraph is one of the action items that seeks to achieve the objective of BEPS project i.e. to tackle base erosion and profit shifting. The MLI will be applicable to a bilateral tax treaty only if both parties to such treaty notify it as a Covered Tax Agreement (CTA). It is imperative to note that Prevention of treaty abuse is a minimum standard covered under Action 6 of the Final BEPS project. Therefore Article 6 in part III of the MLI titled ‘Treaty Abuse’ covers – “Preamble of a Covered Tax Agreement”

- The Preamble text contemplated in the MLI describes the overall purpose of the Convention to implement tax treaty-related measures produced as part of the Final BEPS Package in a swift, co-ordinated and consistent manner across the network of existing tax treaties without the need to bilaterally renegotiate each such treaty\textsuperscript{15}.

- Further paragraph 1 of article 6 is to be included in place of or in the absence of similar Preamble language of the Covered Tax Agreement. Each party must notify OECD of whether each of its Covered Tax Agreements contains Preamble language, and the text of the relevant paragraph. When all contracting parties have made such notification, the Preamble language is to be replaced by the text contained in paragraph 1 of article 6, MLI as follows:

A Covered Tax Agreement shall be modified to include the following preamble text\textsuperscript{16}:

\textit{“Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)"}

\textsuperscript{15} Para 21, OECD Explanatory statement on MLI

\textsuperscript{16} Part III of the MLI – Article 6 titled ‘Treaty Abuse’
The above preamble notes that the Parties recognise the need to ensure that existing agreements for the avoidance of double taxation on income are interpreted to eliminate double taxation with respect to the taxes covered by those agreements without creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in those agreements for the indirect benefit of residents of third jurisdictions).

Paragraph 3 of Article 6 of the MLI has also allows the possibility to include the other part of the preamble of the OECD Model Tax Convention:

“Desiring to further develop their economic relationship and to enhance their cooperation in tax matters”

This in line with India’s objective on tax treaties as specified in Section 90 of the ITA and also in line with preamble of tax treaties entered with many countries. This particular clause was significant and rational behind the Supreme Court in holding treaty shopping is valid on account of economic developments viz, encouragement of mutual trade and investment\(^\text{17}\).

With regards to India’s position on Article 6, it has been silent and has not made any choice with reference to Article 6 of the MLI. So MLI preamble shall not replace existing preamble language in India’s CTA but will be added to the existing preamble text. Therefore, for the treaty entered with Mauritius which currently contains the following preamble:

“The Government of the Republic of India and the Government of Mauritius, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment”. The preamble mentioned in paragraph 1 may trigger for India-Mauritius tax treaty and it will be interesting to note the validity of Azadi Bachao Andolan’s case pursuant to MLI provisions swinging into action.

\(^{17}\) Para 125 in Azadi Bacho Andolan judgement (supra)
Interestingly the India-Mauritius treaty very specifically uses the term “for the encouragement of mutual trade and investment”. Such wordings are not there in any other tax treaties entered by the India with other countries. However, many of the tax treaties entered by India contains the following wordings in its preamble, apart from prevention of double taxation and fiscal evasion, viz, “…promoting economic relationship between two countries”, “promoting economic cooperation between two countries” etc. Therefore, the existing preamble continue to remain and the preamble in Article 6(1) of MLI shall be added along to the existing preamble in light of the fact that India has not made any reservation to Article 6 of the MLI. The result of the preamble addition shall thereby ensure countries do not adopt treaty shopping methodology and in effect render Azadi Bachao Andolan verdict otiose.

Further as mentioned earlier, it is imperative to note here that preamble plays a significant tool for interpretation, as Article 31(2) of the VCLT specifically covers preamble as part of the treaty. Therefore, in case of ambiguity in the text, then the courts can look at preamble to solve the dispute and more importantly apply the principles of international law based on VCLT for arriving at the interpretation.

6 Conclusion: End of Treaty Shopping in post BEPS era?

The Apex Court in Azadi Bachao Andolan (supra) considered the preamble to the India -Mauritius tax treaty inter alia to legalize treaty shopping. It is also worth mentioning here that the Indian Government sanitized the Apex court verdict vide Finance Act 2003 amended by modifying Section 90(1) (a) of the ITA post Azadi Bachao’s judgement as:

“(a) for the granting of relief in respect of---

(i) income on which have been paid both income-tax under this Act and income-tax in that country; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade

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18 India’s tax treaty with Germany, Sweden, Luxembourg, Tanzania, Trinidad and Tobago, Srilanka, Saudi Arabia, Mozambique, Cyprus, Malta, Georgia, Lithuania, Thailand, Norway, Poland, Myanmar, Ireland, Iceland etc.
The above amendment provided huge opportunity for assessees to plan their taxes and in many cases, plan for double non-taxes. Eventually the double tax avoidance agreement paved way of double non-tax avoidance. Thereby enabling base erosion and profit shifting. It is no surprise that the treaty shopping not only enable residents of third country to gain benefit in a bilateral tax treaty, it also enables the residents of the contracting party to misuse a bilateral tax treaty by camouflaging into a resident of a third country and round trip the untaxed, unaccounted money to their home country in a legal manner.

One would have to wait and watch as to whether the OECD’s action items proposed in the BEPS package, will indeed serve its objective. With due respects, in my view the OECD Model conventions which is followed by many countries as part of their bilateral tax treaty were indeed instrumental in promoting double non-taxation and tax avoidances. Interestingly it is worth mentioning here that both OECD and the UN models of tax treaty has left it to the respective countries to draft the preamble in accordance with the constitutional procedures of the countries. Probably as noted by an eminent jurist, the model promoted certain economic philosophy of the wealthy western countries striking balances in economic field for their political reasons\textsuperscript{19}. On a philosophical note, it looks like OECD is paying for its karma as now their own member countries have used these conventions to avoid taxes.

As regards to the preamble to tax treaties as an aid for interpretation, one would hope that the real objective of entering into tax treaty is looked into. Klaus Vogel rightly considers that the purpose of tax treaties is “…to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help avoidance or evasion. True, taxpayers, have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between states and the tax advantages provided by various countries, taxation laws, but it is for the State concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their

\textsuperscript{19} Mr Shivakant Jha’s blog. Shivakantjha.org
bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.”

• The current preamble suggested in the MLI shall hopefully avoid treaty shopping. Historically, preambles have been used by the courts, not only to aid the interpretation of ambiguous sections and to assist in determining the mischief to be remedied by the Act, but also to determine the intentions of Parliament, as context for clarifying the possible meaning of substantive sections, and as a guide for when to limit ‘general’ substantive provisions. Hence one would hope in the case of tax treaties it does live upto the principles of pacta sunt servanda in Article 26, as abuse of tax treaty is indeed subversive of good faith. Interesting times ahead as paradigm shift beckons cross border taxation matters.