"Treaty Override"

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Summary:

1. GAAR provisions in Direct Taxes Code threaten Treaty Shopping etc. Does it amount to Treaty Override! If yes, what are the consequences! And what are the recourses available to the affected parties!

2. U.N. & OECD accept that aggressive tax planning cannot be permitted. Countries affected by Treaty Shopping, Conduit Companies, Thin Capitalisation, Harmful Tax Competition, etc. should protect their tax base by amending domestic legislation. Such amendment does not amount to Treaty Shopping.

3. Through the Direct Taxes Code, Government of India has given a warning to all concerned that it will not tolerate aggressive tax planning. Those who have in the past, resorted to aggressive planning, may set their matters right before 1st April, 2011.

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Short Forms:

CBDT	-	Central Board of Direct Taxes.
COR	-	Country of Residence.
COS	-	Country of Source.
DTA	-	Double Tax Avoidance Agreement.
DTC	-	Direct Taxes Code.
GOI	-	Government of India.
GOM	-	Government of Mauritius.
ITA	-	Indian Income-tax Act.
OECD	-	Organisation for Economic Co-operation & Development
Treaty	-	Double Tax Avoidance Treaty (Agreement).

Core Issues in Treaty Override

1. What is "Treaty Override"?

OECD's **definition** of treaty override: "The term Treaty Override refers to a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that state."

2. Is treaty override "right" or "wrong"?

3. In this paper let us take one illustration. Since **India – Mauritius treaty** has been the most discussed treaty in India, let us take that as an illustration. The principles derived from the discussion would apply to all treaties.

Is it true that if India overrides treaty, it is wrong; but if Mauritius overrides the treaty, it is right!

4.1 **Vienna Convention** – Articles 26 & 31 provide that a Double Tax Avoidance Treaty (Treaty) should be implemented **in good faith**. Article 27 provides that a Government may not invoke its internal law as justification for its failure to perform a treaty. With all these provisions, how can a Government override a treaty!

4.2 Is the obligation of "Implementation in good faith" applicable only to the Governments; or does it apply to the **tax payers** also!

4.3 A treaty is a **contract** between two Governments. The tax payer is not a party to the contract. Is he bound by a contract signed by the Government!

When the tax payer claims relief permitted by a contract signed by the Government, does he also attract the obligations attached with the relief!

5. What are the **consequences** of a Treaty Override?

6. GOI has permitted **treaty shopping** through several tax havens - for more than 15 years. Now if GOI proposes Direct Taxes Code (DTC) where specific provisions are made to disallow treaty shopping, is it treaty override? Is it permissible? Isn't GOI prevented by **Promissory Estoppel**!

7. In case of Treaty Override, what are the **recourses** available? Is the recourse available to the Government of Mauritius only or even to the tax payer?

Let us examine all these issues in depth.

8. We may consider the "Treaty Override" with reference to:

Indian Income-tax Act,

Indian Case Law,

OECD Commentary,

Direct Taxes Code and

Vienna Convention.

Note: References to Government of India, Indian law, etc. are just a matter of convenience. Principles of law discussed here may apply to almost all countries.

I. Preface:

1. **A Double Tax Avoidance Treaty is a Contract between two Sovereign Governments.** It is on a different footing as compared to the contract signed by ordinary citizens/tax payers. If a citizen violates a contract signed by him, other party to the contract has recourse to the court of law or other enforcement agencies of the Government. When a Government violates a contract signed by it, **what is the recourse?**

Since practically there is no recourse available to the aggrieved party, contracts between Governments have to be considered at a different level altogether. For maintenance of good international relations, it is expected that a Government would follow the contract that it signs, in letter and in spirit. It will implement the contract **"In Good Faith".**

When the words "In Good Faith" are used, it necessarily means looking at the spirit of the contract, at the substance of the contract and not merely at the letters of the contract. There is NO room for hyper technical interpretations; twisting of meanings and deriving meanings that were never intended by the parties to the agreement. And there is no going back on one's promises – whether in writing; or apparent by conduct.

Treaty Override violates all these principles.
And yet, treaty override does happen.

2. **Amendments** in domestic law can be of **two different kinds**. Let us consider **illustrations** to understand difference between a Treaty Override (non-permissible); and permissible amendments.

(i) **T.D.S. Rate:** India signs a treaty with another country. The treaty provides that if a non-resident of India earns interest income from India, India will enforce deduction of income-tax at source at a rate not higher than 10%. Government of India (GOI), after signing the treaty, amends the Income-tax Act specifically to provide that tax will be deducted at source @ 15% - not withstanding the treaty. This would be clear treaty override. This is **not permissible** under International Law.

(ii) **Countering Treaty Abuse:** Government of India amends Indian Income-tax Act to prevent treaty shopping. This is anti-Treaty Abuse. Such Amendments to law are clearly permissible. They are not even considered as Treaty Override.

We will discuss in this paper, both kinds of amendments in domestic legislation.

3. Treaty is a **bilateral contract**. It is a contract signed between two Governments. Hence it should normally mean that the contract has been signed with full knowledge, understanding and free consent of both the Governments. (And yet, countries have signed treaties with ignorance of international tax law.)

Domestic Income-tax Act is a **unilateral legislation**. When India passes the Indian Income-tax Act, it does not need any permission from Mauritius or other Governments. Treaty Override would mean that: the Government sends FTD commissioners to Mauritius to sign a treaty; then the Government goes ahead and passes a law contrary to the treaty!

It does not need an expert lawyer or the Vienna Convention to say that **Treaty Override** is wrong. It is wrong because it amounts to the Government going back on its own promise. It is unfair, unethical and hence wrong.

Let us examine the history of India Mauritius treaty.

II. India - Mauritius Treaty:

1. In the **year 1983**, India and Mauritius executed Double Tax Avoidance Treaty (Treaty). At that time, India was heavily regulated economy with very little international investment. Mauritius was essentially a small island with a population less than the population of Borivli (a far suburb of Mumbai). Mauritius had essentially the businesses of fishing, growing sugarcane and tourism. Since it is a far away country, tourism was at low level. The GDP of Mauritius would of course be less than the GDP of Borivli.

2. In this situation, when India signed the treaty, CBDT was liberal. **The OECD model was accepted**. As per the OECD model, **capital** gains arising on transfer of shares and movable properties are taxable in the Country of Residence (COR) and not in the Country of Source (COS). As per the treaty, if a Mauritian resident were to invest in India and earn capital gains; India as COS would not levy any tax on the capital gains. It would be for Mauritius – as COR to levy, or not to levy income-tax on the capital gains earned by its resident. From 1984 to 1992, probably, not even one million dollar would be invested in India by Mauritian residents. (We don't have statistics.)

3. **In 1991**, the then Prime Minister late Mr. Narsimha Rao and the then Finance Minister Dr. Manmohan Singh started **liberalisatio**n of Indian economy. India was being discussed at all international forums. Substantial investment was coming into India. At that time **Mauritius changed all its relevant laws**. Whereas proper Mauritian resident was liable to income-tax @ 35%, an offshore company had an option to select a tax rate from **0% to 30%.** Earlier, foreigners were not allowed to incorporate companies in Mauritius. After the change over, government passed a special law The Mauritius Offshore Business Activities Act, 1992 **(MOBA)**. Foreigners were allowed to incorporate companies in Mauritius.

These offshore companies were not entitled to do business in Mauritius. They could not earn income (except bank interest) from Mauritius. The companies were free to do any business anywhere in the world outside Mauritius.

Since the companies were **registered** in Mauritius, they were treated as **residents** of Mauritius and hence entitled to the benefits of India – Mauritius Double Tax Avoidance **Treaty.**

4. In a conference with Mauritius authorities, following issues were raised. 0% tax means **"no liability to tax".** Even if a company opted to pay tax @ 15% or 30%, it would mean a "gift" by the company to the Government of Mauritius. An "option" to pay tax is not a "liability" to pay tax. Hence the offshore company is not a **"Resident"** of Mauritius; & hence not entitled to Treaty relief. These issues were raised before the Authority for Advance Ruling also. Recognising this, Government of Mauritius amended the law and provided for a 15% compulsory tax. From this tax, an automatic credit for foreign tax is given. Net tax payable in Mauritius comes to 3%. There are many other issues. However, they would not be relevant to our present discussion.

5. The issue is: **Government of Mauritius** (GOM) had signed a treaty in the year 1983 with GOI. It was bound to implement the treaty in good faith. Which means, the treaty benefits would be available to bonafide residents of Mauritius & India. Contrary to this duty, GOM went ahead and **amended its laws with specific intent to permit treaty shopping** by non-residents of Mauritius. This was clearly a "Treaty Override", violation of Articles 26, 27 & 31 of the Vienna Convention. Please note: **The first Treaty Override** for the India – Mauritius Treaty was **made by the Government of Mauritius**.

6. When one party to the contract does not perform the contract in good faith, what are the recourses available to the other party? Again let us consider an illustration.

Mr. A, a buyer enters into a contract with Mr. B, a builder to purchase a flat. The building is yet at planning stage. A will have the flat on the tenth floor. The contract provides for payments in instalments. A is to pay Rs. 10 lakhs every time one floor is constructed. After completing two floors, B stops any further work on the building. However, he demands subsequent instalment payments.

When B does not perform his part of the duty as per his contract, can he insist on A completing his part of the duties?

When Mauritius does a treaty override, can it insist that India must continue to abide by the treaty? Can the tax payers & tax consultants say: Treaty Override by Mauritius is alright; but India cannot override the treaty!

III. Indian Position on Treaty Override:

1. So far, GOI has been very clear. Wherever there are differences between the provisions of the Income-tax Act & the Treaty; Government has agreed that the provisions of the Treaty will prevail.

When some Income-tax officers doubted such a provision, matter went into appeal. Andhra Pradesh High Court in **Vishakhapatnam Port Trust** Case (1983) (144 ITR 146) held that the Treaty shall override the Act.

CBDT accepted this position & issued **Circular No. 333** dated 2nd April, 1982 to confirm its agreement with the HC decision. That ended controversy on this issue. Similar view has been expressed in several cases, notable being - CIT vs. R. M. Muthaiah (1993) 202 ITR 508, CIT vs. SRM Firm (1934) 208 ITR 400, Arabian Express Line Ltd. Of U.K. vs. Union of India (1955) 22 ITR 31.

2. Some treaties signed by India had TDS rates as high as 30% on royalty & FTS payments. Under the Act, GOI progressively reduced these TDS rates to less than 30%. Now the two provisions were different. Act was more beneficial than the treaty. GOI pragmatically made a provision in the Act [Section 90(2)] to provide that where the **Act is more beneficial** to the assessee, Act will prevail over treaty.

3. At the same time, GOI ITA provides for different tax rates for domestic companies and for foreign companies. An issue was raised whether differential tax treatment amounts to violation of "Non-Discrimation Article" (Article 24 in the OECD model). GOI amended section 90, added explanation 1 and provided that such differential rates shall not be considered as "Discrimation".

There is a justification. Domestic companies pay corporate tax and also pay Dividend Distribution Tax (DDT). Foreign companies do not pay DDT. To keep both the kinds of companies at par, a higher rate is provided for foreign companies. It amounts to saying that there will be no discrimination against domestic companies.

4. Whenever controversies arose about availability of a tax treaty. GOI has gone ahead & issued circulars to ensure that the treaty is available to the assessee.

Thus, so far (well, till 31st Dec., 2008) GOI has never committed Treaty Override. (Please see paragraph III.5.) Illustration given in paragraph I.2(i) is hypothetical. GOI has not taken such steps.

5. Position has changed recently. Some people have made massive **abuse of the Treaties**. Treaty Shopping, conversion of Indian black money into white, manipulation of Indian stock markets; etc. have been exposed as big scandals. GOI has realised how the group of people operate & abuse treaties. Hence now GOI has started considering amendment of the law to counter Treaty abuse.

Even now, GOI upholds the normal position that for categorisation, tax rates etc., Treaty shall prevail over the Act. However, wherever a Treaty is abused and the Government of the concerned country is found to be abetting treaty abuse, GOI will take action.

This is discussed in paragraphs III.6 and V.

6. In last one year, India has made serious amendments to Income-tax Act; and proposed new provisions under the DTC - going contrary to International law on International tax. Let us consider macro level aspects to these amendments.

6.1 **(i)** In Ishikawajima Harima Heavy Industries Ltd. Vs. DIT [2007] 288 ITR 408 SC held that GOI has no jurisdiction to impose income-tax on a non-resident's income sourced outside India. When a non-resident renders services outside India, the source of his income is outside India. Hence FTS payments to him cannot be taxed by GOI. SC decision is a simple reiteration of the international law.

(ii) Explanation to Section 9 (at the end of the section, after sub-section 2) added by Finance Act, 2007 attempts to tax non-resident's income even if sourced outside India.

(iii) DTC proposes to override the Supreme Court decision in Ishikawajima case and extend GOI's jurisdiction to tax. Under the well accepted International tax law, a Government cannot tax a Non-Resident's foreign sourced income. However, DTC proposes to ignore this position. To override this decision, DTC proposes **in S. 5(5)** to extend the GOI's tax jurisdiction beyond Indian sourced incomes – even for non-residents.

(iv) Justification for the action: Almost all the governments impose TDS on royalty, FTS etc. irrespective of whether the services are rendered within the country or outside the country. They go by the **"source of payment"** rather than the "source of income". When almost all countries tax on similar lines, can India ignore the global trend & abstain from taxing such incomes!

(v) Right action would be for all Governments to accept a code that they cannot impose tax on the basis of "Payment". This is beyond the scope of work that CBDT would take up. Easier way was to join the world trend and tax incomes beyond jurisdiction. This is what has been done in the proposed section 5(5) of the DTC.

6.2 CBDT **circular 23 of 1969** was a well-considered, well drafted circular accepting correct principles of international taxation. Unfortunately CBDT has scrapped the circular exposing genuine assessees to unfair taxation. Though, in my submission, the circular simply stated the law as it is. By deleting a circular, substantial law does not change.

IV. Following are not Treaty Override:

If a **tax payer** does aggressive tax avoidance contrary to the spirit of the treaty, it is not Treaty Override. It is Tax Avoidance. Concerned Government may take such steps against the tax payer under its own laws, as the Government may consider appropriate.

Similarly, when an **Income-tax Commissioner** passes orders contrary to the spirit of the Treaty, it is not Treaty Override. The tax payer may take up appellate proceedings under domestic Income-tax Act; or go for Mutual Agreement Procedure (MAP) under Article 25 of the Treaty.

V. International Position on Treaty Override:

1. OECD position on Treaty Override:

Please note that amendments to domestic law can be of different manners. As discussed in paragraph I.2 (i) if India amended the law to collect tax @ 15% when treaty permitted only 10%; it would be violation of international law. However, when a country deliberately changes its entire legal system to substantially erode India's tax base, India is **legally permitted to amend its laws.** This is specifically provided **by OECD** in its commentary. Please see the commentary on "Introduction" paragraph 9.2 onwards, and chapters on "Thin Capitalisation" and "Conduit Companies" in part II of OECD Commentary on Model Tax Conventions. Also see several reports by OECD on: Thin Capitalisation, Conduit Companies, Base Companies etc.

2. U.N. Approach on Treaty Abuse:

Please see U. N. report of June, 2009 on "Improper Use of Tax Treaties" It discusses various modes of treaty abuse (or improper use). Some of them being Treaty Shopping, use of Conduit Companies, Base Companies, etc.; & gives several ways of dealing with such treaty abuse. It is taken for granted that a state suffering from treaty abuse must take action to protect its tax base. U.N. report also states that developing countries inexperienced in dealing with international tax matters need help & guidance.

3. Prof. Klaus Vogel's Commentary:

The book **"**Prof. Klaus Vogel on Double Taxation Conventions" – 2005 edition on pages 67 onwards, gives a commentary on Treaty Override. A summary of the commentary is given below:

U.S. Government has passed laws amounting to Treaty Override. There is a difference of opinion within the Government and profession as to whether Government should pass such laws. Constitutionally position is clear. If the U.S. Government passes a law overriding a treaty, such law is valid within U.S.A.

German Government is ready to override treaties to avoid treaty abuse.

In **U. K.** Government is legally competent to override treaties. (See paragraph 135 on pages 70 & 71.)

Late Prof. Vogel's Commentary is **clearly against Treaty Override – even to prevent Treaty Abuse.**

In my humble submission, we the tax advisors and tax payers have made massive abuse of treaty. We have gone ahead and claimed it as our right to abuse the treaty. This is not fair. We are also expected to **apply the Treaty in Good Faith**. Tax payer cannot claim tax reliefs under the Treaty; and ignore the obligations under the Treaty.

VI. GOI's action on tax planning:

1. **In 1993** when Mauritius changed its legal system, India could have cancelled the treaty. However, despite strong protests from several Commissioners of Income-tax, Government did not cancel the treaty. **Dr. Manmohan Singh** publicly stated that he was more interested in **foreign investment** rather than in the income-tax avoided by treaty shopping.

Dr. Manmohan Singh did not remember Mahatma Gandhi's advice: "Ends & Means both must be ethical".

2 Treaty Shopping is certainly unfair. If GOI wanted more investment and was prepared to sacrifice capital gains tax; it should have amended the Income-tax Act and permitted all foreign investment free from capital gains tax. Taxing those investors who come honestly and directly from their country of residence; and not taxing those who do treaty shopping; is certainly wrong.

3 One wrong necessarily entails another wrong and then a series of wrongs. In the years **1999-2000**; Ketan Parekh the famous share broker allegedly abused India – Mauritius treaty & manipulated Indian share market. When the manipulation was exposed, the markets crashed and the whole economy was shattered.

4 In the year 2000, when a few income-tax commissioners passed assessment orders, taxing some specific FIIs who had aggressively avoided taxes; again the markets collapsed. FIIs & banks threatened India. "If India - Mauritius treaty benefit is not granted, foreign investment will flow out hurting Indian economy". Government was scared. World share markets had also gone down because of U.S. dotcom bust. We could not take chances. CBDT chairman came on television & assured that the treaty benefit will be granted. **Circular No. 789** dated 13th April, 2000, was issued to prevent any income-tax commissioners from disallowing the treaty benefit. The tax commissioners who had passed relevant orders were transferred out. FIIs were assured that their benefits will continue.

Is foreign investment really so important!

Let us consider some **economics**. Indian GDP is approximately U.S. $ 1.3 trillions. We save 38% of GDP. Most of it is invested in India. This means, our domestic investment within India is around $ 500 billions. Annual foreign investment may be less than 10% of domestic investment. Government has realised that unduly high importance has been given to foreign investment. The investment is welcome. But not at any cost. And certainly not in an environment where they can threaten the Indian economy.

Having permitted treaty abuse for a long period, when the Government considered the issues coolly, it realised that such a situation cannot be permitted. Result is the GAAR provisions under the DTC.

5. Promissory Estoppel:

Let us see varying views on the principle of Promissory Estoppel. Each paragraph below gives a different view – showing the complexity of the matter.

5.1 Indian History: Serious mistakes were committed by GOI when it signed in the year 1995, treaties with **Malta & Cyprus**. They were tax havens even before India signed the treaties. The issue discussed in paragraph II that Mauritius did not act in Good Faith won't apply here. Cyprus & Malta were publicly known to be tax havens. GOI went ahead with open eyes. And it did not build in any protective provisions to avoid Treaty Shopping, Benami holdings etc.

GOI has permitted treaty shopping for so many years **with full knowledge**. And not just by acts of omission. GOI has actively committed itself to Treaty Shopping by issuing Circular No. 789 dated 13th April, 2000; and by defending the treaty in "**Azadi Bachao Andolan**" case (2003) 263 ITR 706 (SC).

GOI has even signed treaty with **Luxembourg.** GOI is expected to know that Luxembourg is a tax haven. This action supports the view that GOI has, with knowledge, promoted treaty shopping.

5.2 **Under Vienna Convention, Article 45**; India is barred by Promissory Estoppel from preventing Treaty Shopping.

5.3 As decided by the **Supreme Court of India**, Law of Promissory Estoppel does not apply to Parliaments.

5.4 The issue is, how two persons would behave – even if there is no force of law! If the persons are honest, ethical, fair – as Governments are expected to be – then they will behave in "Good Faith" – **irrespective of whether an external force** binds them or not.

5.5 India now ignores Promissory Estoppel and proposes GAAR in DTC. It even proposes to override SC decision in Azadi Bacho Andolan case vide section 258 (8) of the DTC. What are the consequences!

It would be for an expert on International Public Law; and an expert on Indian Constitution to reply. As a layman, I may submit that the draftsman would be in the same position as Arjuna was in the beginning of the war at Kurukshetra. In a Dilemma. With no easy answers. Ultimately, ignoring relationships and all the past incidents, he has to do what is right.

5.6 One may note U.N. report & Indian facts. All of us in India –Tax department, tax payers, tax advisors & even judiciary did not have much exposure to international tax & especially, the aggressive tax planning done by International tax experts & MNCs. In this situation, confusion and incorrect legislation is possible. Once an authority realises that some thing is wrong, other nations have taken remedial actions even twenty years before; no argument can prevent the authority from taking remedial actions.

6. After discussing everything including the opinion of Prof. Klaus Vogel, **what should the draftsman do today, in the Indian context!**

I am quoting from Yoga Vashisthya Book II "Mumukshu Prakarana", Chapter 18, 2nd shloka.

"Even if an ordinary man makes a statement which is just and fair; it should be accepted. And if a statement is unjust and unfair – even if told by a Vedic Rushi; it should be rejected. Man must always follow justice."

Justice lies in stopping Treaty abuse.

(**Note**: this shloka is translated from the book 'Yoga Vasisthya' published by "Sastu Sahitya, Ahmedabad.)

VII. DTC:

1 Treaty Override:

The Direct Taxes Code proposes vide **section 258(8)** to do away with entire arrangement available in the present Income-tax act, & discussed in paragraph III above. Section reads as under:

"Section 258(8) *For the purposes of determining the relationship between a provision of a treaty and this Code,-*

(a) *neither the treaty nor the Code shall have a preferential status by reason of its being a treaty or law; and*
(b) *the provision which is **later in time shall prevail**."*

In simple words, this provision means that the existing priority of the Treaty over the domestic law will be removed. Instead, "Which ever is later" will have the over riding effect. Since DTC would be later than all the treaties signed so far, DTC will override all existing treaties.

Subsequent strategy has not been spelled out in the "Discussion Paper" published with the Draft DTC. However, in several conferences, the TPL commissioners have clarified the strategy as under.

Primarily, with the DTC coming into effect (most probably on 1st April, 2011); all treaties will be subordinated to the DTC. However, the FTD section of the CBDT will issue **fresh protocols** for most of the treaties immediately after 1st April, 2011. With the protocols, the treaties will be "later in time" than the DTC. Hence again, as per S. 258(8), the treaties will prevail over the DTC. Treaties with some tax haven countries, which are being abused, will be renegotiated. If those Governments do not agree on renegotiations, no protocols will be used. Hence those treaties will be sub-ordinate to the DTC.

Under the DTC, anti-abuse provisions of GAAR will be applicable for tax haven countries.

2. GAAR. General Anti Avoidance Rules.

The Direct Taxes Code (DTC) proposes under **section 112** to make a provision that if the tax payer makes certain arrangements specifically to avoid taxes, income-tax commissioner will be authorised to ignore the arrangement. There is no specific mention of treaty shopping. However, GAAR is broad enough to cover Treaty Shopping, Thin Capitalisation, Tax Haven Conduit Companies, etc.

Let us see the position post DTC. Assuming that the GAAR provisions are passed as proposed, what will happen to thousands of offshore – shelf companies opened in certain tax havens!

In my view these companies and the investments in India through them can be considered as **"impermissible avoidance arrangements".** Hence the companies can be ignored and treaty benefits denied.

3. Legal consequences for the assessee.

When a conduit company is ignored, India – Mauritius treaty benefit will not be available to the non-resident investor. However, would it mean that the investor can claim the benefit of the treaty signed by India with the country of residence of the foreign investor?

3.1 For example, NW bank at U.K. invested in India through Mauritius. It is denied India – Mauritius Treaty benefits. Can it claim the benefits of India – U.K. Treaty?

This issue is **not answered by DTC** – Section 112. Absence of an answer in the law means controversies, litigation and different answers by different appellate authorities. It would be advisable to provide complete consequences in the DTC itself.

In my submission, the act of ignoring the impermissible avoidance arrangement should be taken to its **logical conclusion**. What may be ignored is – the tax haven company. However, the substantial fact remains that NW, the U.K. company has invested in India. When the Indian company makes payments of interest/dividend/royalty/FTS etc.; India as the **COS** should deduct taxes at the rates provided in the India – U.K. treaty.

Should U.K., as the **COR,** give credit for taxes paid by the Indian subsidiary of NW - Corporate tax and Dividend Distribution tax! U.K.

permits **Underlying Tax Credits**. And under its **CFC rules**, U.K. Inland Revenue would ignore all "controlled" companies & go right upto the income earning company. Hence it should permit the tax credits. However, I do not know U.K. tax law and cannot suggest what treatment will actually be given in U.K.!

3.2 Let us consider one more **illustration** going a step further.

V. Ltd. of U.K. invested in N. Ltd. of Netherlands. The Dutch company invested in a Cayman Islands subsidiary – which in turn invested in a Mauritius subsidiary – M. Ltd. The Mauritian company invested in an Indian company.

M. Ltd. claims zero capital gains tax under India – Mauritius Treaty. CIT disallows the treaty benefit U/s. 112 of the DTC.

India has treaties with Mauritius, Netherlands & U.K. Can V. Ltd. claim any of these treaty benefits! Some views on both sides are given below in paragraph 3.3.

3.3 **(i)** The CIT may examine each company in the series. All the companies found to be devoid of substance may be ignored. The first company in the series with substance may be recognised. If there is a treaty with that COR, relevant treaty benefits may be given.

(ii) Granting treaty benefits in this manner may amount to **encouraging the tax planning**. Tax payer will try his best. If he can't get one benefit; okay. He will get the 2nd or the 3rd or the 4th level benefit!!

(iii) When a particular arrangement is ignored, the matter must be taken to its **logical conclusion**. The assessee cannot be left in a void. There may be a penalty for the tax planning. Still, the ultimate beneficial owner should get treaty benefit.

3.4 **Contradictory Views:**

We are not interpreting law. We are discussing merits of a possible future law. Tax payer and tax departments are bound to have contradictory views on tax planning and its consequences. All this discussion is in the realm of "fairness", "reasonableness", etc. People planning their affairs should consider a fact that India has declared through DTC, that it will not tolerate aggressive tax planning & treaty shopping. Ordinary people may avoid tax havens. There are people who have started lobbying to GOI & CBDT to restore Status Quo. Let us see the drama. Who wins the game!

4. **Limitations of GAAR:**

4.1 Assume that DTC is passed with GAAR provisions. All "file/shelf" companies will be in trouble. However, consider the illustration of an FII. It opens a company in Singapore. Opens a small office and employs few clerks and a peon. Total expenses of establishment exceed Singapore $ 200,000 per year.

4.2 Under the **protocol** signed by **India with Singapore**, such a company will be treated as bonafide resident of Singapore. It may invest $ 500 million in India. Entire management of the funds may happen in New York or London.

4.3 Can the income-tax commissioner ignore the Singapore company and refuse to give DTA relief?

4.4 Even if a commissioner disallows the treaty benefit, prima facie, it appears that a Court of Law would hold India responsible to abide by the protocol. Having signed the protocol, it would be difficult for India to say that the conduit company is not a resident of Singapore.

4.5 **DTC** proposes to do away with the principle of Treaty overriding the domestic Act. "Whichever is later" will prevail. However, as planned by the Government of India, immediately after passing the DTC, GOI will issue protocols making the treaties "later than DTC". Hence again the India – Singapore treaty will override DTC. Result: Even after DTC, FIIs or anyone who can afford to spend Singapore $ 200,000 per year; will be able to do treaty shopping.

4.6 It is known that **within U.S.A. state of Delaware is a tax haven.** It cannot help in evading U.S. taxes. However it can help in evading Indian or any other taxes. **U.K.** also has laws & systems which **help tax avoidance** by residents of countries other than U.K. As has been planned by the CBDT, in case of both these countries, treaty will override GAAR provisions. Entire effort of DTC can be frustrated by certain tax planning.

5. Suggestion:

If GOI wants to avoid failure of anti-avoidance provisions, probably the following approach may be considered.

The treaties should override the domestic law as far as tax rate determination and categorisation of income (articles 6 to 22) and elimination of double tax (article 23) are concerned. However, when it comes to GAAR and Transfer Pricing provisions (all anti-avoidance provisions), the domestic law should override the treaty. (Also see Annexure II.)

In other words,
(i) For normal provisions, Treaty will override domestic law.
(ii) For anti-avoidance provisions, domestic law will override Treaty.

This purpose can be achieved by a **different draft of S. 258(8):**

"For the purposes of determining the relationship between a provision of a treaty and this Code - Wherever the provisions of the code listed below are applicable, the same shall prevail over the treaty. In all other cases, between the Code & the Treaty, whichever provision is more beneficial to the assessee shall prevail.

"Sections 5, 104 to 114." (Some provisions may be added.)

This modification will have following impacts:

(i) It will restore the legal position of 'treaty overriding Income-tax Act' for normal provisions of the treaty - which is Government's intention; and

(ii) GAAR will prevail over treaty even if a treaty or protocol is signed later than DTC.

(iii) More important, if DTC is not modified, a later interpretation by a Court may permit treaty abuse. However, the proposed language will not permit such interpretations.

(iv) It will remove considerable anxiety caused in the minds of Indian as well as foreign tax payers.

(v) It will also eliminate the need for all the negotiations & protocols with more than seventy countries that are necessary under the present DTC draft.

To avoid even GAAR being frustrated, in addition to the above, Government may consider making a specific provision in the DTC that under Indian Direct Taxes, **Substance will prevail over Form.** (This again is an involved matter needing a full separate paper.)

6. Protest against Treaty Override:

Who can protest against a Treaty Override! Can individual tax payer protest when Treaty Override takes place? If GAAR is challenged in an Indian Court, what may happen?

If challenged in an International Court of law, what may happen?

Treaties have to be interpreted in the light of their **object & purpose.**

Purpose is to avoid Double Tax.
AND
To avoid tax evasion.

Hence making anti-abuse provisions would be in keeping with the purpose of the treaty. No one can say that a treaty's purpose is to encourage tax avoidance.

Treaty shopping is clearly treaty abuse & tax avoidance. Since Indian Courts have not respected this principle, GOI has to go ahead & make necessary laws.

7. Macro Level Consequences.

What will happen once DTC is passed – assuming it is passed as per present draft. In case of tax havens, DTC will Override Treaty. Hence GAAR will be applicable.

7.1 Treaty Shopping will be avoided.
Thin Capitalisation will be avoided.
Pure shelf/ file company business will be affected.

However, once substance is provided – as in the case of Singapore; or even in Mauritius; Courts will quite likely, hold treaty application valid. GAAR may be frustrated. If the law prescribes "Substance Over Form" such risks may be avoided.

The issue is: "Substance Over Form" has impact on both sides. Even tax payers will be able to claim relief under this principle in appropriate cases. Income-tax department will not be able to disallow certain reliefs on technical grounds. That would be better. **Fairness on both sides.**

7.2 When one country overrides a treaty, the other country has a right to terminate the treaty – Vienna Convention, Article 60. **However, within the country, the law remains valid.**

GAAR is a very **potent weapon**. If it is left as proposed in the DTC, there can be GAAR abuse by the assessing officers resulting in substantial harassment and litigation. Powerful politicians using Government machinery for settling their private scores has become so common. Left to itself, GAAR abuse can be far worse than Treaty Abuse. It can also cause more loss to Indian economy.

Unfortunately, it has happened a hundred times in India. Some one avoids tax. He wins in the Court. Hence Government amends the law with deeming provisions. The tax planner is a few steps ahead of Government. However, the innocent ordinary tax payer suffers because the corrupt tax officer is now armed with more potent weapons. And the assessee is exposed without adequate protection. It needs to be repeated that present law & DTC do not provide adequate protection to honest tax payers.

Substantial checks and balances need to be provided over GAAR. This is a separate subject again.

7.3 We may also consider that: India – Mauritius treaty is only one treaty. It is a bad case. **Bad case should not be allowed to make bad law.** In normal circumstances, when deliberate treaty abuse is not involved, Treaties should not be overridden. Even if a particular interpretation/ clause causes some losses to the GOI, a contract once signed, cannot be violated.

In normal circumstances, no Treaty Override should be made.

In case of Treaty abuse, amending the law to protect legitimate revenue does not amount to treaty override. It is Government's duty to protect its revenue.

VIII. Summary:

1. OECD has defined Treaty Override. It has further specified when it is permitted & when it is not permitted.

Under the DTC, GOI has proposed GAAR. This is anti-avoidance provision. It is clearly permitted. There is no Treaty Override involved here. In fact, it is GOI's duty to bring in such provisions. In this case, with all humility, I submit to disagree from the views of Late Prof. Klaus Vogel.

2. The Treaty Override committed by Mauritius in the year 1992 is wrong.

Treaty Override committed by any one – whether India or Mauritius or any other Government, is wrong. **Every Government's** duty is to implement the Treaty in Good Faith.

3. **Recourse:** When a Country Overrides the Treaty, another country has the options as under:

(i) Relax & watch haemorrhage of tax revenues. India did this from 1993 to 2009.

(ii) Scrap the Treaty. India has avoided this.

(iii) Amend the domestic law adequately to plug the tax planning & tax avoidance. DTC proposes to do this. Government is doing its duty.

Thanks

Rashmin Chandulal Sanghvi

Annexure I

Extract from Vienna Convention

Article 26 "Pacta sunt servanda"

Every treaty in force is binding upon the parties to it and must be performed by them in good faith.

Article 27 Internal law and observance of treaties

A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.

Article 31 General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 45 Loss of a right to invoke a ground for invalidating, terminating, withdrawing from or suspending the operation of a treaty.

A State may no longer invoke a ground for invalidating, terminating, withdrawing from or suspending the operation of a treaty under articles 46 to 50 or articles 60 and 62 if, after becoming aware of the facts:

(a) it shall have expressly agreed that the treaty is valid or remains in force or continues in operation, as the case may be; or

(b) it must by reason of its conduct be considered as having acquiesced in the validity of the treaty or in its maintenance in force or in operation, as the case may be.

Annexure II

A Functional analysis of Overriding Provisions.

Which provisions may have priority! It may be noticed that it is not always that treaty overrides domestic law. Both have their own functions. Both are complimentary.

Sr. No.	Domestic Law	Treaty	Remarks
1.	Categorisation of income	Categorisation of income	Two categories may be different. For avoidance of double tax, treaty will prevail.
2.	COS tax rates: Domestic law sub-servient to Treaty. Domestic law sub-servient to Treaty.	Maximum tax rate that the COS may levy on gross income. Business income. Tax on net profits by COR; & by host country of PE.	For tax rate determination, Treaty overrides domestic law.
3.	Computation of taxable income.	No Provision.	Domestic law will prevail.
4.	Tax rate in COR.	No provision.	Domestic law will prevail.
5.	Elimination of Double tax. In India, section 90. Credit system adopted.	COR to give credit or exemption for COS tax.	Treaty to override domestic law.
6.	GAAR, Transfer Pricing etc.	Article 9 on transfer pricing, Limitation of benefit clause.	Treaty Abuse. It is accepted that domestic law Overrides Treaty.

What is the function of a treaty!

Its function is to avoid double tax. For this purpose, COS places restrictions on its tax collection. COR gives credit for taxes paid in COS (or exempts incomes taxed in COS).

Treaty does not make provisions for computation of income, or for avoidance of tax planning, penalty, prosecution etc. [Except for limited provisions of (i) Limitation of Benefits clause and (ii) Associated Enterprises.]

A treaty can override domestic law only for its intended function of avoiding double tax. For anti-avoidance provisions; the domestic law has to override the treaty.

(This is a small note on a vast subject. Idea is only to high light that treaty is not a complete legislation by itself. Even in ordinary circumstances, it cannot prevail over the domestic legislation in several fields.)