Preamble to Multilateral Instrument & Treaty Shopping

Date: August 28,2019

K. Vaitheeswaran (Advocate)

Background

Foreign Investments in India are routed through different countries either for business reasons or for tax benefits depending upon the bilateral treaty between the respective countries. For many years it has been established that tax evasion is illegal; tax avoidance is always a matter of debate and tax planning is legal (though GAAR is a different story). Arranging affairs in a manner which is most tax efficient and beneficial to the entity or the owners has been a key factor in decision making.

Generally, developing countries would be focused on ensuring that the country does not lose its legitimate share of taxes and attempts would be made through domestic law and interpretation of existing law to find ways and means of creating a nexus to the source country.

The entire Base Erosion and Profit Shifting (BEPS) Action Plans seem to be driven by developed countries and it is interesting to note that the language adopted in some of the treaties seem to mirror language used normally in Indian Tax Statutes.

Multi-Lateral Convention

A significant impact was caused to the structure of taxation of foreign investments made in India and this change was brought about and subsequently crystallised by virtue of India signing and ratifying the "*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*" at Paris, France on 07.06.2017. Over the following years, amendments were made based on deliberations at the international level to modify this instrument to bring into its ambit changes that were deemed necessary at the discussions. This instrument came into force on 01.07.2018 when five member nations had ratified the instrument and made it part of their municipal structures. India made its ratification on 01.04.2019 after taking into consideration the changes brought about in the years preceding the ratification to completely suit its needs and to achieve its goal of ease of doing business. The changes are effective from 01.10.2019.

Double Non-Taxation

Double Non-Taxation was an issue that plagued countries since much of corporate tax revenue was being lost due to aggressive tax planning by multinational enterprises that conduct businesses across borders. A scenario of double non-taxation is inevitable when certain enterprises use the treaties or the lack of such treaties to their advantage whereby profits are artificially shifted from a high tax / low capital jurisdiction to a low tax jurisdiction through tax planning tools. In many cases, the tax planning tools involve creating layers of companies across different countries through artificial structures sans commercial purpose.

Amendments in the MLI – Article 6(1) – Minimum Standards

Article 6(1) of the MLI provides that an existing treaty (Covered Tax Agreement) shall be modified to include the following Preamble:

Intending to eliminate double taxation with respect to 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).

The Preamble itself sets the tone and indicates in clear terms the objective of the entire exercise. This is a major departure from the Preamble generally adopted in CTAs where the preamble is to avoid double taxation and prevent fiscal evasion. Some treaties had additional aspects such as encouragement of mutual trade and investment (India – Mauritius); promoting mutual economic relations (India – Germany / India – Lithuania); promoting economic cooperation (India – Indonesia, India – Hungary, India – Luxembourg, India –

Cyprus).

Article 6 of the MLI urges the member nations to add as part of their CTA's a perambulatory clause detailing the purpose, based on which the contracting parties have entered into this agreement. With the inclusion of this Article the instrument establishes a 'minimum standard' with respect to eliminating treaty abuse.

India has not expressed any reservations with reference to Article 6(1) and hence when contracting nations notify the MLI, the CTAs between India and such contracting nations would stand amended with the Preamble as contemplated in Article 6(1).

The Preamble that is to be added by way of this Article to a nation's CTA, maybe in the absence of, addition to or replacing existing perambulatory texts in the CTA. However, in case a nation's CTA already covers this aspect, they can make a reservation to this Article.

Overarching Preamble or Logical Destination?

The language used in the preamble indicates significant passage of time in the context of the observation of the Federal Court in the case of **John N. Gladden Vs. Her Majesty The Queen** [1] 'Contrary to an ordinary taxing statute, a tax treaty or convention must be given a liberal interpretation with a view to implement the true intentions of the parties. A literal or legalistic interpretation must be avoided and the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.'

The observation of the Supreme Court in the case of **Union of India Vs. Azadi Bachao Andolan** [2] that treaty shopping is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two contracting states now forms the latter part of the preamble. A commercial expression of a state of affairs has now forayed into the treaty space.

It is also interesting to note that in the **Azadi Bachao** case, the Revenue contended that anti-abuse provisions need not be incorporated in the treaty since it is assumed that the treaty would be only used for the benefit of the parties. Reliance was also placed on the 'Report of The Working Group on Non- Resident Taxation' dated 03.01.2003. The Supreme Court in page 749 held that the recommendations of The Working Group are about *what the law ought to be and a pointer to the Parliament and the Executive for incorporating suitable limitation provisions in the treaty itself or by domestic legislation and this per se does not render an attempt by a resident of a third country to take advantage of the DTAC illegal.*

The AP High Court in the case of **Sanofi Pasteur Holding SA Vs. Department of Revenue** [3] held that treaty provisions are expressions of sovereign policy, of more than one sovereign State, negotiated and entered into at a political/ diplomatic level and have several explicit and/or subliminal and unarticulated considerations as their bases. A tax treaty must be seen in the context of aiding commercial relations between treaty partners and as being essentially a bargain between contracting States as to the division of tax revenues between them in respect of income falling to be taxed in both jurisdictions. The Court further observes that many developed countries tolerate or encourage even treaty shopping even if it were unintended, improper or unjustified for other and non-tax reasons unless it leads to significant loss of tax revenue. Developing countries need foreign investments and treaty shopping opportunities could be an additional factor to attract investments. The language used in the latter part of the preamble indicates that much water has flown and countries have now attached importance to tax revenues compared to other non-tax objectives.

India Story

India signed the Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting on 07.06.2017. The Convention was ratified and India deposited the instrument of ratification along with a list of CTA's, reservations and notifications to the depository on 25.07.2019. The date of entry into force of the said Convention has been identified as 01.10.2019 and Notification No. S.O. 2887(E) dated 09.08.2017 has been issued in exercise of the powers conferred by Section 90(1).

Whether amendment to Section 90 is required?

Section 90(1) empowers the Central Government to issue notification to make such provisions as may be necessary for implementing the agreement. Section 90(1)(a) deals various aspects such as granting of relief; avoidance of double taxation; exchange of information for prevention of evasion or avoidance of tax or investigation of such cases and recovery of tax.

It appears therefore, that the four limbs of Section 90(1) may not be adequate to support amendments to a treaty with a powerful Preamble such as the one referred to in Article 6 of MLI. In effect while the objective of Section 90(1) is to prevent double taxation, the MLI now specifies even the format of such prevention by

insisting that the exercise of elimination of double taxation should be done *without creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance*. This limiting factor is not expressly specified in Section 90(1). Further, the Preamble also provides that the elimination of double taxation should be done without creating opportunities through *treaty shopping arrangements*.

The Supreme Court, in the case of **Azadi Bachao Andolan**, in India legitimized 'treaty shopping'; whether Section 90(1) in its current format is adequate to support the Preamble to the MLI being part of all CTA's is now a matter of debate.

Conclusion

The debate between tax avoidance and tax planning has gone on for many years and when the Preamble itself states that opportunities should not be created for non-taxation or reduced taxation through tax evasion or avoidance, the script for significant tax litigation in international tax space has been clearly written. The characters for the film to unfold would be multinational enterprises who will have to reexamine their existing structure, strategies and arrangements in the light of the Preamble. The technicians would be the consultants and professionals who would come up with innovative solutions. The Revenue would act as a censor board viewing the film from the prism of established concepts and armed with the new Preamble. Like any other controversial film, the Courts will have to decide between legitimate tax planning vs. tax avoidance. In all these battles, the basic principle of economic substance over legal form would come into play.

---

[1] 85 DTC 5188 at 5190

[2] (2003) 263 ITR 703 at 746 / [TS-5-SC-2003-O]

[3] (2013) 354 ITR 316 at Pg. 432 / [TS-57-HC-2013(ANDHRA PRADESH)-O]