

## LIMITATION OF BENEFIT – THE ROUTE TO CURTAIL TAX AVOIDANCE OR A DISGUISE: AN INDIAN PERSPECTIVE

Gaurav Shukla\*

**Abstract:** A Double Taxation Avoidance Convention (DTAC) between two States is one of the instruments to enhance bilateral trade and commerce. DTAC is having two aims, the first is to eliminate double taxation and the second to check tax avoidance. This article focuses on one of the methods for eliminating tax avoidance, popularly known as Limitation of Benefit (LOB). The LOB method discussed in this article may help the readers to understand the menace of tax avoidance, technicalities of the method, and how the LOB clause in DTAC can help the exchequer to restrict the practices leading to revenue loss with the help of tax avoidance practices.

**Keywords:** Tax Avoidance, Limitation of Benefit, Tax Treaties, Double Non-Taxation

### INTRODUCTION

Double Taxation Avoidance Convention (DTAC) is an international agreement<sup>1</sup> used to denote an agreement between two (or more) countries for the avoidance of Juridical Double Taxation. There are various types of tax treaties of which the most common are treaties for the avoidance of double taxation on income and capital (usually known as a comprehensive income tax treaty). In addition to comprehensive agreements, there are Limited Agreements, Exchange of Information agreements, and The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting (MLI). The preamble of most the agreements is just not for eliminating double taxation but they are also used to curtail tax avoidance and evasion.<sup>2</sup>

DTAC offers a range of tax advantages which countries agree to grant to each other to prevent juridical double taxation (Columbus Container Services BVBA & Co.v Finanzamt Bielefeld-Innenstadt, 2007)<sup>3</sup> and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of persons, etc. These tax advantages are done through the allocation of taxing rights between the Contracting States,<sup>4</sup> such as re-

\* Dr. Gaurav Shukla, Lecturer of Law, University of South Pacific, Suva, Fiji

<sup>1</sup> McNAIR, A. *The Law of Treaties*. Oxford University Press, 1986; BROWNLIE, I. *Principles of Public International Law*. Oxford University Press, 1973; SCHWARZENBERGER, G., BROWN, E. *A Manual of International Law*. Milton: Professional Book Limited, 1976; Double taxation avoidance agreement; Double taxation avoidance convention; Double taxation avoidance treaty; DTA; terms generally used to denote an agreement between two (or more) countries for the avoidance of double taxation. In fact, there are various types of tax treaty of which the most common are treaties for the avoidance of double taxation of income and capital (usually known as a comprehensive income tax treaty). Such treaties are also commonly expressed to be aimed at the prevention of fiscal evasion. ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. 7<sup>th</sup> ed. IBDF, 2015, p.411.

<sup>2</sup> ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. 7<sup>th</sup> ed. IBDF, 2015.

<sup>3</sup> Where the same income is being taxed twice in the hands of the same taxpayer are being referred to as juridical double taxation. UNITED NATIONS. Analytical and historical review of international double taxation and tax evasion and avoidance. In: United Nations [online]. 01. 01. 2014 [2018-08-10], p.5. Available at: <[https://www.un.org/esa/ffd/wp-content/uploads/2014/10/2STM\\_Taxation-EC18-2006-7-part1-R.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2014/10/2STM_Taxation-EC18-2006-7-part1-R.pdf)>.

<sup>4</sup> Art. 13(6) of the United Nations Model Double Taxation Convention between Developed and Developing Countries. New York: United Nations, 2011 (“hereinafter UN MC, 2011”).

duced withholding taxes<sup>5</sup> on dividends, interest and royalties<sup>6</sup> and a foreign tax credit or exemption to eliminate double taxation.<sup>7</sup>

DTAC aims to waive “tax claims”<sup>8</sup> or, more illustratively, they divide the “tax sources”, and the “taxable objects” among themselves.<sup>9</sup> The experts in the early 1920s under the umbrella of League of Nations describe this division as a method of classification of items and their assignments to the Contracting States. While the English lawyers called it ‘classification and assignment rule’, the German jurists called it ‘the distributive rule’ (Verteilungsnorm).<sup>10</sup> Commenting particularly on the German Double Taxation Convention with the United States, Vogel comments: “Thus, it is said that the treaty prevents not only ‘current’ but also merely ‘potential’ double taxation”. Further, according to Vogel, “only in exceptional cases, and only when expressly agreed to by the parties, is an exemption in one of the Contracting States dependent upon whether the income or capital is taxable in the other Contracting State, or upon whether it is taxed there.”<sup>11</sup>

Tax advantages under DTAC are one of the factors to attract the attention of tax planners. For countries, it is a matter of ensuring that the tax treaty is not improperly used and the tax advantage does not operate to the benefit of persons for whom it is not intended. At the same time, the tax advantage must be granted to those who are genuinely entitled to it. Even the contracting states may refuse the tax advantage in cases where there is an improper use of the tax treaty and it will also defeat the objective of the contracting states entering into the tax treaty, and the reciprocity will be lost. Improper use of DTAC leads to tax avoidance, the most commonly used device for tax avoidance is treaty shopping.<sup>12</sup> However, the two model conventions the OECD and the UN model conventions are silent as to what constitutes the proper use of Tax Treaties.

Once the model conventions describe what amounts to proper use of Tax Treaties it would easier for the Contracting States to identify the improper use of Tax Treaties and treaty shopping is considered one of the most used strategies for avoiding taxes.<sup>13</sup> In this

---

<sup>5</sup> Tax on income imposed at source, i.e. a third party is charged with the task of deducting the tax from certain kinds of payments and remitting that amount to the Government. ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. p. 449.

<sup>6</sup> Arts. 10, 11 and 12 of the UN MC, 2011.

<sup>7</sup> Arts. 23A or B of the UN MC, 2011.

<sup>8</sup> VOGEL, K. *Double Taxation Conventions: A Commentary to the OECD, UN, U.S. – Model Conventions for the Avoidance of Double Taxation of Income and Capital*. Kluwer Law and Taxation, 1991, p. 62.

<sup>9</sup> Tax treaty between Germany and Netherlands signed in 2012. 1965 III Federal Tax Gazette (Bundessteuerblatt) BStBl 352, 353 (regarding the German treaty with the Netherlands).

<sup>10</sup> VOGEL, K. *Double Taxation Conventions: A Commentary to the OECD, UN, U.S. – Model Conventions for the Avoidance of Double Taxation of Income and Capital*; IT-3(1) Mumbai v. Ramesh Kumar Goenka 2010 39 SOT 132 (Mum), para.6.

<sup>11</sup> *Ibid.*

<sup>12</sup> In *Crown Forest Industries Ltd v. Canada*, the Supreme Court of Canada described “treaty shopping” as a transaction “in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states of DTC, 1995 2 S.C.R. 802 at para. 58. See also, *Bombay High Court definition of treaty shopping in Azadi Bacho Andolan v. Union of India*, 2004, para.11. “Treaty Shopping”, by which the resident of a third country takes advantage of the provisions of the Agreement, is illegal and thus necessarily forbidden.

<sup>13</sup> SHUKLA, G. et. al. Tax Effects of Treaty Shopping and OECD’s BEPS Implications. *FIIB Business Review*. 2020, Vol. 9, No. 2, pp.85-93, [2021-02-05]. Available at: <<https://journals.sagepub.com/doi/abs/10.1177/2319714520907245>>.

inquest to counter treaty shopping the Limitation Of Benefit (LOB) clause is inserted in DTAC, specifically to deal with tax avoidance caused by treaty shopping through setting out the rules in which the contracting states confirm the treaty benefits to taxpayers that have a sufficient economic nexus with a contracting state.<sup>14</sup>

The paper is structured in such a way that the readers can have the idea of different approaches for curtailing the menace of treaty shopping. In this context, the paper gives a fair idea of different approaches listed within the ambit of OECD's Double Taxation Conventions and the Use of Conduit Company Report, 1986. The approaches or in other words tests proposed by this report do have some defeats which are explicit from the language used in different approaches. The paper touches the Indian Tax Treaties as a batch mark for analyzing the different tests and their practical problems faced by the exchequer. It is pertinent to examine whether the LOB clause is the best mechanism to curtail practices like treaty shopping and will increase the investment or it will reduce the investment. In concluding remarks the research concludes that it may create uncertainty and reduce the investment to some extent.

## 1. BENEFICIAL OWNER OR LOB: WHICH ONE IS MORE EFFECTIVE?

LOB clause is a narrow approach in determining who is the actual beneficiary of the transaction. In other words, the LOB clause is a part of the concept of the Beneficial Owner (hereinafter BO). 'BO' is not defined in every tax treaty inked between countries today which opens the door for disputes on the interpretation of the concept and the result may lead to tax treaty shopping and excessive tax avoidance.<sup>15</sup>

International tax literature highlights three different meanings of the term "BO" as used in the OECD Model Tax Convention on Income and on Capital, 2017 (hereinafter OECD MC, 2017) & UN Model Double Tax Convention between Developed and Developing Countries, 2017 (UN MC, 2017) i.e.:

1. The domestic law meaning in common law jurisdictions, as imported in the UN & OECD MC, to be deemed the ordinary meaning of the term;
2. The meaning of the term as emerging from the Commentary to the Model conventions (UN & OECD MC); and;
3. The meaning of the term "BO" as the person to whom income is attributed under the domestic tax laws of the Residence and/or the Source State.<sup>16</sup>

<sup>14</sup> BORREGO, F. *Limitation on benefits clauses in double taxation conventions*, *Eucotax Series on European Taxation*. Vol. 12. Hague: Kluwer Law International, 2006, pp. 113 et seqq.

<sup>15</sup> MEYER, S. P. The meaning of Beneficial Owner and the use thereof for tax treaty shopping and tax avoidance. Mini dissertation. In: *University of Pretoria* [online]. 2010 [2021-02-05]. Available at: <<https://repository.up.ac.za/bitstream/handle/2263/26693/dissertation.pdf;jsessionid=E2FF369C9334CC31484784DDFF765A49?sequence=1>>.

<sup>16</sup> Articles of the OECD Model Tax Convention on Income and Capital. 2017: Commentary on Art. 1 of OECD MC, 2010, para. 10 and Commentary on Art. 1 of UN MC, 2011, para 31; Commentary on Art. 10 of OECD MC, 2010, paras. 12-12.2 and Commentary on Art. 10 of UN MC, 2011 para 13 and OECD Committee on Fiscal Affairs, Double Taxation and the Use of Conduit Companies, para. 14.

According to Arts. 10-12 of the OECD & UN MC, the source state of dividends, interest, and royalties are only required to grant a reduction or exemption from withholding tax where the “BO” of the income is a resident of the other contracting state. This requirement was introduced as an anti-abuse tool, particularly concerning treaty shopping structures involving interposed conduit entities.<sup>17</sup> However, it is not entirely clear how the beneficial-ownership requirement should be interpreted. Broadly speaking, two contrasting interpretations can be identified.

First, a liberal approach is possible, that it is to find out who is the ultimate beneficiary of the income, i.e. the person who reaps the economic benefits, is the beneficial owner, even if the income has passed through one or more conduit entities. Accordingly, an interposed conduit entity that receives the income in its name and for its account, but passes it on to the ultimate beneficiary, cannot be considered to be the beneficial owner.<sup>18</sup>

Secondly, a narrow approach analyses the underlying contract from a legal perspective to verify whether the interposed entity is acting in the capacity of an agent or nominee. In other words, a person may not benefit under the treaty if the person is not a resident of one of the Contracting States, as defined, for the treaty. This approach is also termed as “anti-treaty shopping” or “LOB” clauses.<sup>19</sup>

For instance, the tax treaty between the Netherlands and the United Kingdom, which was signed on 7<sup>th</sup> November 1980, contained the following provision: “*No relief shall be available under this Article if it was the main purpose or one of the main purposes of any person concerned with the assignment of the interest, or with the creation or assignment of the debt-claim in respect of which the interest is paid, or with the establishment, acquisition or maintenance of the company that is the beneficial owner of the interest and the conduct of its operations, to take advantage of this Article*”. In any case, where a Contracting State intends to apply this paragraph, its competent authority shall in advance consult with the competent authority of the other Contracting.<sup>20</sup> A similar provision is also included concerning royalties in Art. 12 within the same tax treaty between the U.K and the Netherlands.<sup>21</sup>

The OECD & UN MC contains an extensive section on the improper use of tax treaties in the commentary to Art. 1. Commentary on Art. 1 along with Double Taxation Convention and the use of Conduit Company Report, OECD, 1986 which contains a text suggestion for LOB provisions, apart from these specific anti-avoidance rules (SAAR), it is a standard policy of countries not to enter into a tax treaty relation with tax havens and to carve out privileged tax regimes from the application of tax treaties.

---

<sup>17</sup> Ibid.

<sup>18</sup> WARD, D. A. Access to Tax Treaty Benefits. In: *Government of Canada* [online]. 2008 [2021-02-05]. Available at: <[http://publications.gc.ca/collections/collection\\_2010/fin/F34-3-12-2009-eng.pdf](http://publications.gc.ca/collections/collection_2010/fin/F34-3-12-2009-eng.pdf)>.

<sup>19</sup> Ibid.

<sup>20</sup> Art. 11(5) of U.K-Netherlands DTAC. 1980. [online]. [2018-08-18]. Available at: <<http://www.hmrc.gov.uk/tax-treaties/in-force/2008-netherlands-uk-dtc.pdf>>.

<sup>21</sup> ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. Provision to prevent tax treaty shopping, e.g. through the use of a so called conduit company. LOB provisions may limit benefits to companies which have a certain minimum level of local ownership (“look-through approach”), deny benefits to companies which benefit from a privileged tax regime (“exclusion approach”) or which are not subject to tax in respect of the income in question (“subject-to-tax approach”), or which pay on more than a certain proportion of the income in the tax-deductible form (“channel approach”) or “base erosion rule”).

## 2. DEVELOPMENT OF LOB

LOB provision is the instrument of the United States to curtail treaty shopping; the footsteps of the development of LOB can be traced back from LOB provisions in the U.S. income tax treaties of the 1940s and 1950s. These provisions were narrow in scope but subjective in nature.<sup>22</sup> They typically limited the availability of the reduced withholding rate on dividends but did not affect other treaty benefits. The limitations applied only to certain related corporations, not to other persons.

They applied to any corporate relationship “arranged or maintained” primarily to obtain the treaty’s reduced withholding rate on dividends. Although this “arranged or maintained” test was vague and subjective, the treaties did not guide its application. The treaties negotiated by the United States in the 1960s and 1970s contained more sophisticated limitation provisions.<sup>23</sup> These provisions, typically captioned “Investment and Holding Companies,” applied, as before, only to corporations. They limited not only the availability of the reduced withholding rate on dividends, but also the treaty benefits on interest, royalties, and, in some cases, capital gains. Their scope was, therefore, broader than that of the earlier provisions.<sup>24</sup>

Treaties of the 1960s and 1970s introduced a more objective test for the LOB. A corporation was denied treaty benefits thereunder only if two additional tests were satisfied. The first test, commonly called the foreign ownership test, was satisfied if 25% or more of the corporation’s capital was owned, directly or indirectly, by persons other than an individual resident in the corporation’s state of residence. This test was designed to prevent third-country residents from obtaining treaty benefits that were intended only for residents of the Contracting States. The second test was satisfied if the law of the corporation’s state of residence provided “special measures” making the corporate income tax on foreign-source income “substantially less” than that of domestic-source business profits. This special measures test was designed to deny treaty rates for income not subject to “full” taxation in the corporation’s state of residence.<sup>25</sup>

The LOB principle was further refined in the treaties negotiated by the United States in the late 1970s and early 1980s. The provisions adopted during this period typically followed the official U.S. negotiating position, as outlined in Art. 16 (LOB) of the Model Treaty

---

<sup>22</sup> The former U.S. income tax treaties with Denmark (Art. VI). Convention with Denmark Relating to Double Taxation. 1948. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/denmark.pdf>>.

<sup>23</sup> Art.16 of the United States – Trinidad and Tobago Income Tax Convention. 1970. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/trinidad.pdf>>; Art. 20 of the United States – Norway Income and Property Tax Convention. 1971. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/norway.pdf>>; Art. 16 of the United States – United Kingdom Income Tax Convention. 1975. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/uk.pdf>>; Art. 27 of the Tax Convention with Iceland. 1975. In: *Internal Revenue Service* [online]. [2018-08-15]. Available at: <<http://www.irs.gov/pub/irs-trty/iceland.pdf>>.

<sup>24</sup> *Ibid.*, also see, Art. 16 of the Model Income Tax Treaty issued by the US Department of the Treasury on 17 May 1977.

<sup>25</sup> *United States – Trinidad and Tobago Income Tax Convention; United States – Norway Income and Property Tax Convention; Tax Convention with Iceland.*

proposed by the U.S. Department of the Treasury on 16 June 1981 (the 1981 Model).<sup>26</sup> Provisions following the 1981 Model differed from their precursors in several important respects. They limited treaty benefits for all types of income, not only for specified types of investment. They also broadened the class of persons subject to the limitation to include not only corporations but also non-corporate persons other than individuals.

### 3. LIMITATION-ON-BENEFITS CLAUSES IN TAX TREATIES

A LOB clause specifically deals with treaty shopping patterns and sets forth the rules by which the Contracting States elect “to confine source-country treaty benefits to entities that are true residents of the treaty partner and are fully taxable in that country.”<sup>27</sup>

Hoping to prevent persons not entitled to treaty benefits from obtaining them by artifice, trickle or guile; U.S. Model Convention, 2006 [hereinafter U.S. MC, 2006] has adopted a separate derogation rule for that purpose in Art. 16.<sup>28</sup> The first version of that rule, issued in 1977, was designed as an exception to Arts. 10 to 12 of U.S. MC. It stipulated that if 25% or more of the capital of a company that is a resident of a contracting State is owned ... by individuals who are not residents of that State, and if by reasons of special measures the tax imposed by that State on that company concerning dividends, interest or royalties arising in the other contracting State is substantially less than the tax generally imposed by the first-mentioned State, the latter is in turn entitled to tax them.<sup>29</sup>

The rule was, therefore, to a certain extent expanded ‘subject to tax’ clause. The U.S. issued two new versions of that rule, one in June and the other in December 1981. Both correspond in that they go beyond the 1977 version by providing that a person (other than an individual) shall not be entitled to treaty benefits if the person fails to establish the business connection.<sup>30</sup>

Earlier, LOB clauses generally denied treaty benefits where entities were formed with the “principal purpose” of taking advantage of the treaty benefits.<sup>31</sup> Because of the difficulty of applying rules based on taxpayers’ subjective intent, the LOB clauses later were generally based on objective criteria, such as the percentage of ownership in the entity by residents of the third state (the qualified-resident criteria) (United States Model Income

---

<sup>26</sup> *United States – Trinidad and Tobago Income Tax Convention; United States – Norway Income and Property Tax Convention; Tax Convention with Iceland*; Art. 17 of the United States – Jamaica Income Tax Convention. 1981. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/jamaica.pdf>>; Art. 16 of the United States – New Zealand Income Tax Convention. 1982. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/newzld.pdf>>; Art. 26 of the Tax Convention with the Republic of Cyprus. 1986. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/cyprus.pdf>>.

<sup>27</sup> POSTLEWATE, P. F., MAKARSKI, D. S. The A. L. I. Tax Treaty Study – A Critique and A Modest Proposal. *Tax Law*. 1999, Vol. 52, p. 779.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*

<sup>30</sup> VOGEL, K. *Double Taxation Conventions: A Commentary to the OECD, UN, U.S. – Model Conventions for the Avoidance of Double Taxation of Income and Capital*. p. 62.

<sup>31</sup> KORNIKOVA, A. A. Solving the Problem of Tax-treaty Shopping through the Use of Limitation on Benefits Provisions. *Richmond Journal of Global Law and Business*. 2008, Vol. 2, p. 249.

Tax Convention. 1981).<sup>32</sup> Gradually, the criteria used in LOB clauses have grown increasingly sophisticated. For instance, the LOB provision in the U.S. MC, 2006 first lists several taxpayers who are entitled to the treaty benefits (qualified residents) and subsequently provides for alternative tests for qualifying items of income, regardless of whether the taxpayer meets the criteria or not.<sup>33</sup>

Accordingly, is the first test laid down in Art. 22 of U.S. MC, 2006 specifies that, if a resident of Contracting State does not come under the category of “qualified person”, the taxpayer will not be entitled to the tax benefits under the DTAC. Further, the article lays down the criteria to become a qualified person. For example, if a resident is a non-listed company then ‘two-pArt. ownership’ and ‘base the erosion test’ (IBFD International Glossary. 2009)<sup>34</sup> is applied. In respect of pArt. ownership, firstly, at least 50% of the shares (or other beneficial interests) in the company must be owned for at least half of the taxable year by residents entitled to treaty benefits. Secondly, concerning base erosion test, less than 50% of the company’s gross income for the taxable year is paid or accrued, directly or indirectly, to persons not entitled to treaty benefits in the form of payments that are deductible in the company’s state of residence (excluding arm’s-length payments)<sup>35</sup> in the ordinary course of business.<sup>36</sup>

The second test, the alternative test in this LOB clause concerns qualifying items of income, regardless of whether the resident is a qualified person. Under this test, treaty benefits are also granted to residents of a contracting state concerning an item of income derived from the other state if the resident actively conducts a trade or business in his home state,<sup>37</sup> and the income derived from the other contracting state is derived “in connection with” or is “incidental to” that trade or business.<sup>38</sup> This provision allows testing the economic connection of the taxpayer to the claimed country of residence, which is ultimately the core issue in treaty shopping cases.

Despite this shift towards the use of objective elements, several modern tax treaties contain (objective) LOB provisions that are supplemented with or replaced by subjective elements. For instance, the LOB clause in the U.S. MC, 2006 provides that, if neither of the two tests referred to above is met, the competent authority may nevertheless grant the

<sup>32</sup> E.g. Art. 16 of the 1981 US Model, which imposed a 75% ownership requirement.

<sup>33</sup> Model Tax Convention (Condensed Version) OECD. 2017; Art. 22 of the US MC, 2006. Commentary on Art. 1, Para. 20, OECD MC, 2010.

<sup>34</sup> ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. 6<sup>th</sup> ed. Amsterdam: IBFD, 2009.

<sup>35</sup> Arm’s Length Principle requires associated enterprises to charge the same prices, royalties and other fees in relation to a controlled transaction that would be charged by independent parties in an uncontrolled transaction in otherwise comparable circumstances. ROGERS-GLABUSH, J. *IBFD International Tax Glossary*. 7<sup>th</sup> ed. IBFD, 2015. p. 23.

<sup>36</sup> Model Tax Convention (Condensed Version) – OECD. 2010; also see Art. 24 of Indo-US DTAC, 1999. See further, *Union of India v. Azadi Bacho Andolan* 2003 263ITR706(SC), para 104.

<sup>37</sup> Art. 22 of the U.S. MC, 2006. Other than the business of making or managing investments for the resident’s own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer.

<sup>38</sup> *Ibid.* Moreover, if a resident of a contracting state derives an item of income from a trade or business activity conducted in the other contracting state, the income is only considered to be incidental to or derived in connection with the trade or business in the home state if the trade or business activity carried on in the home state is substantial in relation to the trade or business activity carried on in the other contracting state.

treaty benefits if the arrangement did not have one of its principal purposes to obtain tax treaty benefits (Model Tax Convention (Condensed Version) – OECD, 2010).<sup>39</sup>

Another example of a change in dimensions of the LOB clause, the Belgian Model Convention, 2010 provides as follows: *“a resident of a Contracting State shall not receive the benefit of any reduction in or from tax provided for in the Convention by the other Contracting State if the main purposes of such resident or a person connected with such resident was to obtain the benefits of the Convention.”*<sup>40</sup> Such exceptions serve to counter situations where the objective test is met, but where the tax motive is so distinct that it outweighs the economic nexus, (e.g. where tax benefit is out of all proportion to the economic importance of the transaction) therefore in these circumstances the treaty benefits are denied.

The application of such subjective tests may lead to considerable difficulties in practice, as it is exceedingly difficult to demonstrate, for instance, that an arrangement has been entered into for the main purposes of taking advantage of a particular treaty article. Therefore, the question arises whether the addition of a subjective test in the tax treaty is advisable. In other words, should a taxpayer be granted treaty benefits as soon as the objective test is met – i.e. when there is a sufficient economic nexus with the purported state of residence – or should the treaty benefits also be warranted by the taxpayer’s intentions?

These question does not reduce the importance of having LOB clause in DTAC, as Supreme Court of India in the Azadi Bacho Andolan case highlighted the importance of inclusion of LOB clause, within DTAC, to stop tax avoidance with the help of Conduit companies.<sup>41</sup> In this case, the Court was examining the validity of circular no. 789 dated 13/4/2000 issued by Central Board of Direct Taxes (CBDT) by which if the company gets Certificate of Resident from Mauritius than that company would be eligible to tax benefits under Indo-Mauritius DTAC concerning Capital Gian Tax.<sup>42</sup>

The importance of the LOB clause can also be evidenced through the Protocol, 2004 between the U.S and Netherland DTAC, 1992 inserted new LOB provision, which expands the former LOB provision, as it adds a substantial presence requirement to the publicly traded test if: (a) it is not managed and controlled in the country in which it is a resident; and (b) its stock is not primarily traded on a stock exchange within the company’s ‘primary economic zone.’<sup>43</sup>

#### 4. DIFFERENT TESTS OR APPROACHES UNDER THE LIMITATION OF BENEFICIAL PROVISIONS

Limiting the treaty benefits through LOB, as discussed above, broadly consist of two-fold tests; subjective & objective. However, these broader tests are applied through different tests or approaches. LOB provisions may limit benefits to companies which have a cer-

<sup>39</sup> Model Tax Convention (Condensed Version) – OECD, 2010; also see, Art. 28 of India-Armenia DTAC, 2004.

<sup>40</sup> Art. 27 of the Belgian Model Convention, 2010.

<sup>41</sup> Union of India v. Azadi Bacho Andolan 2003 263ITR706(SC), para 114.

<sup>42</sup> Ibid., para 9.

<sup>43</sup> SAUDERS, R. MILES D., WILLIAMS, R., VAN DER MERWE, D. *The principles of International Tax Planning*. Ifs, 2005, p. 153.

tain minimum level of local ownership (“look-through approach”), or companies which are benefited from a privileged tax regime (“exclusion approach”) or that have are not subject to tax in respect of the income in question (“subject-to-tax approach”), or which pay on more than a certain proportion of the income in the tax-deductible form (“channel approach” or “base erosion rule”).

#### 4.1 Look-Through Test or Approach or The Direct Approach

The first method is the direct or look-through method.<sup>44</sup> The “look-through approach” (“piercing the veil of the company”) is the most direct way of attacking the conduit problem.<sup>45</sup> This method would allow treaty benefits to flow to a company in the other contracting state only so far as its shares are held by residents of that State. This method is a gloss on the beneficial ownership test because it limits benefits to reflect the proportion of shares in the company which is beneficially owned by residents of the contracting States. This approach focuses on direct and indirect ownership, looking at whether the recipient of the payment is owned and controlled by the third-country resident.<sup>46</sup>

This test is designed to establish whether or not a legal entity established in a resident state receiving income and claiming an exemption from withholding tax, or a reduced withholding tax rate, in a source state is owned, directly or indirectly, by persons who are not residents of one of the contracting states<sup>47</sup> if the answer to the question is positive, the legal entity is denied treaty benefits. Look-through clauses are, however, more of a technical or numerical.

The typical wording of the clause reads as follows: *‘A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.’*<sup>48</sup> It is up to the contracting state to agree on the criteria according to which a company would be considered to be owned or controlled by non-residents.<sup>49</sup>

One of the finest examples of the look-through approach is Art. 24 of Indo-US DTAC, addresses only the entitlement of tax benefits to a person that is a resident of a contracting state and derives income from the other Contracting State. Thus, to fall within the scope of Art. 24, the person claiming benefits must be a resident of a Contracting State, as defined in Art. 4 of the Indo-US DTAC. A person’s residence for Art. 24, is usually easily determined by reference to Art. 4, which generally looks towards the domestic law of the concerned state.<sup>50</sup>

<sup>44</sup> U.N Centre on Transnational Corporation, International Income Taxation and Developing Countries, U.N. Doc. ST/CTC/56, (1988), at 11.

<sup>45</sup> Double Taxation Convention and the use of Conduit Company Report. OECD, 1986, para. 23-28.

<sup>46</sup> *Ibid.*

<sup>47</sup> VITKO, V. The Use of Tax Treaties and Treaty Shopping: Determining the Dividing Line. *Bulletin for International Taxation*. 2013, Vol. 67, No. 1, p. 6.

<sup>48</sup> Commentary on Art. 1 of OECD MC, 2010, para. 13.

<sup>49</sup> *Ibid.*

<sup>50</sup> Art. 24 & 4 of Indo-US DTAC, 1990.

However, as indicated in the Commentary to Art. 4 of OECD MC, the resident under Art. 4 is not always immediately obvious. Before determining its entitlement to benefits under Art. 24, a person should therefore first confirm its residential status under Art. 4.<sup>51</sup> E.g., if a person other than an individual or a company is a resident of both contracting states; the competent authorities of the contracting states shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.<sup>52</sup>

Under Art. 4, pass-through entities such as partnerships, trusts, and estates are subject to a “look-through” test. Art. 4(b) provides: In the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.<sup>53</sup>

In Groupe Industrial Marcel Dassault<sup>54</sup> the taxpayer company A owned all the shares of another French company (hereinafter “the French holding company”). The French holding company owned 80 % share capital of an Indian company (hereinafter “the Indian company”). Subsequently, the taxpayer company B acquired 20 % of the share capital of the French rolling company. Thereafter, taxpayer company A and taxpayer company B decided to sell their shareholding in the French holding company to another (unrelated) French company (hereinafter “Sanofi”). As a result of the acquisition of the French holding company, in effect, Sanofi acquired the majority of the shares of the Indian company.

The issue involved in this case was that the taxpayer company A and the taxpayer company B sought an advance ruling from the Authority of Advance Ruling (hereinafter AAR) to confirm that any capital gains from the sale of their shareholding in the French holding company were not taxable in India under Art. 14 of the treaty.<sup>55</sup>

AAR while applying the principle of “Look-through” held, that, since the transfer of shares of the French holding company to Sanofi was preceded by a series of transactions *inter se* the taxpayer companies and the French holding company, there appeared to be a pre-ordained scheme to effectively transfer the shares of the Indian company and, at the same time, an attempt to avoid capital gains tax in India. For that reason, the AAR found it appropriate to refrain from providing a ruling.<sup>56</sup>

The taxpayer companies contended before the AAR that Art. 14(5)<sup>57</sup> of the treaty did not permit a ‘Look-through approach’. Therefore, as per the taxpayer companies, a transaction involving the sale of the shares of the French holding company could not be deemed as a transaction for the sale of the shares of the Indian company. Alternatively, as per the taxpayer companies, even if Art. 14(5) of the treaty did not apply in the present

---

<sup>51</sup> Ibid.; Commentary on Art. 4 of OECD MC, 2010 (in general).

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

<sup>54</sup> AAR No. 846 & 847 of 2009, New Delhi, decided on 28<sup>th</sup> Nov 2011.

<sup>55</sup> Indo-France DTAC, 1992.

<sup>56</sup> AAR No. 846 & 847 of 2009, New Delhi, decided on 28<sup>th</sup> Nov 2011.

<sup>57</sup> Art. 14(5) of Indo-France DTAC, 1992, “Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least 10% in a company which is a resident of a Contracting State may be taxed in that Contracting State.”

case; any capital gains derived by the taxpayer companies were exempt from tax in India given Art. 14(6)<sup>58</sup> of the treaty.

According to AAR and as per a literal interpretation of Art. 14(5) of the treaty, any capital gains derived by the taxpayer companies from the sale of the shares of the French holding company were taxable only in France. But, the AAR preferred a purposive construction of Art. 14(5) of the treaty as per which (impliedly) the sale of shares of the French holding company should be deemed as the sale of shares of the Indian company. On that basis, the AAR concluded that any capital gains derived by the taxpayer companies were taxable in India.<sup>59</sup>

However, in Vodafone's case, Indian Supreme Court while discussing the use of the word indirect in Section 9(1) (i) of the Indian Income Tax Act, 1961, illustrated that the word indirect cannot be read based on purposive construction. The question of providing "look through" in the statute or the treaty is a matter of policy. It is to be expressly provided for in the statute or the treaty. Similarly, the LOB has to be expressly provided for in the treaty. Such clauses cannot be read into the Section by interpretation.<sup>60</sup>

Court further held, that legal doctrines like "Limitation of Benefits" and "look through" are matters of policy. It is for the Government of the day to have them incorporated in the Treaties and the laws to avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws.<sup>61</sup> Court view concerning LOB provision is clear, that first it should be incorporated in the concerned treaty and then it can be used for limiting the benefits.

## 4.2 The Channel Test or Base Erosion Test

The conduit problem is dealt with a more straightforward way by inserting a provision that would single out cases of improper use concerning the conduit arrangements themselves.<sup>62</sup> The channel test, also called base the erosion test, that tries to catch intermediary entities whose tax base is eroded in favor of non-contracting state residents through the payment of interest or royalties or by the discharge of obligations. This test is designed to establish whether or not the tax base of the company in the residence state is eroded by more than 50% by payments to non-resident related entities.<sup>63</sup> If the answer to the question is positive, the legal entity is denied treaty benefits.

The drafting of these kinds of provisions may be in form of, where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State; a)

---

<sup>58</sup> Art. 14(6) of Indo-France DTAC, 1992. Gains from the alienation of any property other than that mentioned in paragraphs 1, 2, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

<sup>59</sup> AAR No. 846 & 847 of 2009, New Delhi, decided on 28<sup>th</sup> Nov 2011.

<sup>60</sup> Vodafone International Holding B.V v. Union of India, (2012)6SCC613, para. 71.

<sup>61</sup> *Ibid.*, para. 91.

<sup>62</sup> Commentary on Art. 1 of OECD MC, 2010, para 13; also see Art. 28 of THE Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes. 1989. In: *Internal Revenue Service* [online]. [2021-01-31]. Available at: <<http://www.irs.gov/pub/irs-trty/germany.pdf>>.

<sup>63</sup> *Ibid.*

have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of participation or otherwise, or b) exercise directly or indirectly, alone or together, the management or control of such company any provision of this Convention conferring an exemption from, or a reduction of, the tax shall not apply if more than 50% of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes).<sup>64</sup>

This approach would be satisfactory in covering a broad spectrum of cases typically involving improper use of tax treaties like: a) Cases of mere administration of assets; b) the so-called “stepping-stone strategies”; c) other cases where income is merely transmitted through conduit companies to minimize taxes.<sup>65</sup> This approach would not be particularly successful in dealing with cases where income is passed on in the form of a dividend or loan. Furthermore, it could have the effect of denying relief to the bonafide claimants.<sup>66</sup>

After the OECD’s BEPS report of 2015, the objective of the tax treaties is not only for Avoidance of Double Taxation but also to Prevent Fiscal Evasion. India and Austria entered into the agreement known as “The Multilateral Convention To Implement Tax Treaty Related.

Measures To Prevent Base Erosion And Profit Shifting (MLI)” on June 7, 2017, amended the preamble of the Indo-Austria DTAC as “*Intending to eliminate double taxation with respect to the taxes covered by this Convention 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 [Convention] for the indirect benefit of residents of third jurisdictions)*”. And also incorporated the Principle Purpose Test in these wordings, “Notwithstanding any provisions of [*the Convention*], a benefit under [*the Convention*] shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless it is established that granting that benefit in these circumstances would be in accordance with the objective and purpose of the relevant provisions of [*the Convention*]”.<sup>67</sup> The Indo-Australia MLI, 2017 in its purpose determines that the treaty is for the elimination of double taxation without creating opportunities for double non-taxation or reduced tax through practices like treaty shopping which are aimed to benefit the resident of Non-Contracting States. To find out whether the resident of the non-contracting state is closely related to an enterprise is determined through the percentage of the benefit, aggregate vote and value, etc and if the resident of non-contracting state owns 50% or more than 50%, directly or indirectly of the beneficial interest, or regarding companies more than 50% of the aggregative vote and value of the

---

<sup>64</sup> OECD Model Tax Convention, 2017, para. 17.

<sup>65</sup> Ibid., Double Taxation Convention and the use of Conduit Company Report, OECD, 1986, para. 36-41.

<sup>66</sup> U.N Centre on Transnational Corporation, International Income Taxation and Developing Countries, U.N. Doc. ST/CTC/56, (1988), at 15.

<sup>67</sup> Indo-Austria MLI, 2017 – see Double Taxation Avoidance Agreements. In: *Indian Income Tax Department* [online]. [2021-01-31]. Available at: <<https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx>>.

company's shares or the beneficial equity interest in the company will be considered as associated enterprise subject to Anti-Avoidance Rules.<sup>68</sup>

The same kind of provisions are been incorporated in Indo-Belgium MLI, 1993, Indo-Canada MLI, 1996, the Canadian Treaty with India also consists of Principle Purpose Test along with a restriction on Capital Gains which is as follows: *“For purposes of [this Agreement], gains derived by a resident of a [Contracting State] from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other [Contracting State] if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 percent of their value directly or indirectly from immovable property (real property) situated in that other [Contracting State]”* (Indo-Canadian MLI, 2017).<sup>69</sup>

### 4.3 The Exclusion Test

Often conduit situations can be created only by the use of tax-exempted (or nearly tax-exempted) companies that may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies (Double Taxation Convention and the use of Conduit Company Report, OECD, 1986; OECD Model Tax Convention, 2017).<sup>70</sup> The exclusion approach denies treaty benefits to companies that are tax-exempted or nearly tax-exempted.

This is the case when the resident country gives qualifying companies tax privilege assimilating them to non-resident companies. An exclusion clause would read as follows:

‘No provision of the Convention conferring an exemption from, or reduction of, the tax shall apply to income received or paid by a company as defined under section [...] of [...] the Act, or under any similar provision enacted by [...] after the ratification of the convention (OECD Model Tax Convention, 2017).’<sup>71</sup>

Exclusion provisions are considered to be clear, simple, and straightforward measures to prevent treaty-shopping (by conduit companies because the preferential tax regimes which the “exclusion” approach targets typically aim at attracting such companies) (OECD Model Tax Convention, 2017).<sup>72</sup> The exclusion test is intended to define whether or not the legal entity established in a residence state receiving income and claiming an exemption from a withholding tax, or a reduced withholding tax rate, in a source state is a tax-exempt or nearly tax-exempt entity<sup>73</sup> if the answer to the question is positive, the legal entity is denied treaty benefits.

<sup>68</sup> Ibid.

<sup>69</sup> Synthesised Text of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) and the Agreement between the Government of the Republic of India and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital. In: *Indian Income Tax Department* [online]. [2021-01-31]. Available at: <<https://www.incometaxindia.gov.in/dtaa/synthesised-text-of-the-ml-and-india-canada-dtaa.pdf>>.

<sup>70</sup> OECD MC, 2017, para 21; Double Taxation Convention and the use of Conduit Company Report. OECD, 1986, para. 26-28.

<sup>71</sup> OECD MC, 2017.

<sup>72</sup> OECD MC, 2017.

<sup>73</sup> VITKO, V. *The Use of Tax Treaties and Treaty Shopping: Determining the Dividing Line*. p. 7.

OECD Commentary suggested different exclusion provisions, which can be included while entering into DTAC by the Contracting States, such as the exclusion of entities from treaty benefits which enjoy preferential tax treatment in their state of residence concerning their characteristic as defined in the commercial law or the tax law of a country,<sup>74</sup> exclusion from the relief of income received or paid by such company, while the company itself remains a treaty subject (which means that it remains subject to e.g. Arts. 24-26 OECD MC), one which further reduces the scope of the exclusion to certain types of income only (e.g. investment income and directors' fees)<sup>75</sup> or exclusion clause purports to deny treaty benefits to certain types of income that are preferentially taxed in the State of residence of the recipient.

The treaty could otherwise provide that no provision in the treaty which confers an exemption or a reduction of tax is to apply to income received by such a company. Both the Fiscal Committee and the Ad Hoc Group considered this an important instrument to curtail treaty shopping for the State that has created special privileges.<sup>76</sup>

It is to my surprise that the exclusion approach is to target the preferential tax regimes, however, the Global dimensions suggest a different picture. Many countries have made themselves preferential regime in the form of Patent Box Regimes, that includes India, U.K., France, Italy, Netherlands, Cyprus, etc.<sup>77</sup> The exclusion approach is more refined than the look-through approach as it primarily focuses on the companies enjoying the preferential treatment, however, this approach does not curb treaty shopping and restricts the conduit and stepping stone conduits companies.<sup>78</sup> Article 28 of Indo-Columbia 2011 provides LOB clause which consists of Principal Purpose Test (PPT) and excludes those legal entities which do not have sufficient economic activities from receiving the treaty benefits (Art. 28 Indo-Columbia DTAC, 2011; Art. 28 Indo-Estonia DTAC, 2012; Art. 28 Indo-Ethiopia, DTAC, 2013; Indo-Fiji, 2014).<sup>79</sup>

#### 4.4 Subject-to-tax test

This test was first proposed by the OECD in the Conduit Company Report, 1986. The subject-to-tax test resembles the exclusion test. A provision of this sort would limit the relief from one country's tax under a treaty with another country if such persons are not subject to tax on that income in the other country. This is to be considered in line with the principal purpose of the OECD, i.e. the avoidance of double taxation.<sup>80</sup>

---

<sup>74</sup> JIMÉNEZ, M. A. The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries? *Bulletin for International Taxation*. 2004, Vol. 58, No. 1, pp. 20–22. Where it is impossible to identify such companies, an alternative provision is proposed.

<sup>75</sup> *Ibid.*

<sup>76</sup> *Ibid.*

<sup>77</sup> SHUKLA, G. et al. Special Treatment of Innovative Income. *Taxmann*. 2018, pp. 1–17.

<sup>78</sup> WEEGHEL, S. *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and United States*. Kluwer International, 1998, p. 214.

<sup>79</sup> Double Taxation Avoidance Agreements. In: *Indian Income Tax Department* [online]. [2021-01-31]. Available at: <<https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx>>.

<sup>80</sup> OECD MC, 2017, para 15; Double Taxation Convention and the use of Conduit Company Report. OECD, 1986, para. 29-36.

General subject-to-tax provisions provide that treaty benefits in the State of the source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation.<sup>81</sup>

Judge Berner in *Weiser v HMRC*, 2012 has excellently explained the difference between ‘subject to tax’ and ‘liable to tax’. He wrote that a person is liable to tax if the connecting elements with a state are the same as those of persons who are fully liable and actually subject to tax, maybe he is not subject to tax on different kinds of income by the virtue of special provisions of his state of residence (*Weiser v HMRC* [2012] TC 02178; [2012] UKFTT 501 (TC)).

A safeguarding provision of this kind could have the following wording: Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State *a)* have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of participation or otherwise, or *b)* exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, the tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law.<sup>82</sup>

The subject-to-tax test seeks the answer to the question of whether or not the income received from the source state (dividends, interest, or royalties) is subject to tax in the residence state. If the answer to the question is negative, the legal entity is denied treaty benefits.<sup>83</sup> The OECD considered it useful, especially in the case of States with a well-developed economic structure and complex tax law.<sup>84</sup>

The UK in its many treaties has used the subject-to-tax approach and it relates to every kind of income that may be in the form of dividend, interest, royalties, capital gains, etc. Art. XI(2) of the Israel-UK DTAC, 1977 that provides that, “*Any pension ... derived from sources within the United Kingdom by an individual who is a resident of Israel and subject to Israel tax in respect thereof, shall be exempt from United Kingdom tax*” (Croner-i, 2020).<sup>85</sup> The same kind of provisions one can find in Art. 6 Antigua-UK DTAC, 1947, Art. 11 Oman-UK, DTAC, 1998, Art. 8A Israel-UK DTAC, 1962, and Art. 9 Greece-UK DTAC, 1953. At the present scenario there is the more sophisticated version of the subject-to-tax approach, for example, the Art. 17 UK-German DTAC, as amended by the protocol of 2014, states that “*Subject to the provisions of paragraph 2 of Article 18, pensions, other similar remuneration or annuities arising in a Contracting State and paid to a resident of the other Contracting State, shall be taxable only in that other State.*”<sup>86</sup>

<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid.

<sup>85</sup> 25-400 Subject-to-tax approach. In: *Croner-i Library* [online]. [2021-01-31]. Available at: <[https://library.croner.co.uk/cch\\_uk/stt/25-400](https://library.croner.co.uk/cch_uk/stt/25-400)>; Protocol amending the 1977 UK/Israel Double Taxation Convention. In: *GOV.UK* [online]. [2021-01-31]. Available at: <[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/844141/UK-Israel\\_Protocol.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/844141/UK-Israel_Protocol.pdf)>.

<sup>86</sup> UK/Germany Double Taxation Convention (As Amended). In: *GOV.UK* [online]. [2021-01-31]. Available at: <[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/734388/2010\\_Germany-UK\\_Double\\_Taxation\\_Convention\\_as\\_amended\\_by\\_the\\_2014\\_Protocol\\_-\\_in\\_force.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/734388/2010_Germany-UK_Double_Taxation_Convention_as_amended_by_the_2014_Protocol_-_in_force.pdf)>.

## 5. INDIAN DOUBLE TAXATION AVOIDANCE CONVENTIONS AND LOB PROVISIONS

Indian DTACs establish three ways by which an entity can demonstrate that it is justified in receiving the treaty benefits: (1) an objective test, (2) a subjective test, and (3) a decision by the competent authority of the source State. Many of these standards are not unlike the U.S. model and the texts of earlier treaties as each of the tests look for a substantial nexus with the residence country in the form of either substantial residence or business nexus. The the third test, the competent authority test, states that a person that is not entitled to the benefits of this Convention according to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines<sup>87</sup> that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes of obtaining benefits under the Convention.<sup>88</sup>

The first test is an objective one as it identifies generally four classes of persons that are automatically qualified to receive treaty benefits. These persons include individuals, governments, public companies, and entities that meet the two-pArt. ownership and base erosion test. It employs a beneficial ownership test that requires more than 50% of the beneficial interest in such person (or in the case of a company, more than 50% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes.<sup>89</sup>

Concerning companies, the provision further explains that more than 50% of the number of shares of each class of the company's shares must be owned by residents of the contracting States a direct method, as a way of identifying conduit companies.<sup>90</sup>

Indian DTACs employ a base erosion test that the person will not be entitled to the benefits of the agreement if more than 50%<sup>91</sup> or substantial part.<sup>92</sup> of the person's gross income for the taxable year is paid or payable directly or indirectly to persons who are not residents of either of the Contracting States in the form of payments<sup>93</sup> (including liabilities for interest or royalties) companies<sup>94</sup> that are deductible for computation of tax covered under the agreement in the person's state of residence. Essentially, this provision denies relief

---

<sup>87</sup> Indo-US DTAC, 1990.

<sup>88</sup> Art. 28(5) of the Indo-Armenia DTAC, 2004; Art. 24(4) of the Indo-Iceland DTAC, 2008; Art. 28(3) of the Indo-United Mexican States DTAC, 2010; Art. 28(4) of the Indo-Tajikistan DTAC, 2009.

<sup>89</sup> Indo-US DTAC, 1990; Art. 28(2) of the Indo-Armenia DTAC; Art. 24(2) of the Indo-Iceland DTAC; Art. 28(2) of the Indo-United Mexican States DTAC; and Art. 28(2) of the Indo-Tajikistan DTAC.

<sup>90</sup> *Ibid.*

<sup>91</sup> Provision to Art. 28(2) of the Indo-Tajikistan DTAC, 2009, provision to Art. 24(2) of the Indo-Iceland DTAC, 2008, provision to Art. 28(2) of the Indo-United Mexican States DTAC, 2010.

<sup>92</sup> Art. 24(1) (b) of the Indo-US DTAC, 1990.

<sup>93</sup> Indo-US Double Taxation Agreement Convention, 1990; Indo-Armenia DTAC, 2004; Indo-Iceland DTAC, 2008; Indo-United Mexican States DTAC, 2010.

<sup>94</sup> Indo-US Double Taxation Agreement Convention, 1990; Indo-Armenia DTAC, 2004; Indo-Iceland DTAC, 2008; Indo-United Mexican States DTAC, 2010; Indo-Tajikistan DTAC, 2009.

when the entity can minimize substantially its effective tax burden in the residence country.<sup>95</sup>

Indian DTACs provides a subjective test that allows treaty benefits to flow when an “active business connection” can be demonstrated by the entity, if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the state of residence (other than the business of making or managing investments for the resident’s account unless these activities are banking, insurance or security activities)<sup>96</sup> and that resident satisfied the other conditions of the agreement for obtaining such benefits.<sup>97</sup>

If the resident or any of its associated enterprises carries on business activity in the other Contracting State which gives rise to an item of income, “active business connection” shall apply to such item only if the business activity in the state of residence is substantial concerning the business carried on in the state of source. Whether a business activity is substantial, will be determined based on all the facts and circumstances.<sup>98</sup>

In determining active business connection the Contracting State should take into consideration; (a) activities conducted by a partnership in which that person is a partner and activities conducted by the persons connected to such person shall be deemed to be conducted by such person; (b) a person shall be connected to another if one possesses at least 50% of the beneficial interest in the other (or, in the case of a company, at least 50% of the aggregate vote and value of the company’s shares) or another person possesses, directly or indirectly, at least 50% of the beneficial interest (or, in the case of a company, at least 50% of the aggregate vote and value of the company’s shares) in each person. In any case, a person shall be considered to be connected to another if, based on all the facts and circumstances, one has the control of the other or both are under the control of the same person or persons.<sup>99</sup>

India in recent years has negotiated for the incorporation of the LOB clause in some of the most improperly used tax treaties, like the infamous Indo-Mauritius DTAC, 1984, Indo-Singapore DTAC, 1994, and others (Indian Income Tax Department, 2020).<sup>100</sup> In 2018-19 the FDI from Singapore was the highest with 14,632 (US\$ million) surpassing Mauritius with 6,570 (US\$ million) of FDI.<sup>101</sup> In Indo-Mauritius DTAC a new Article was inserted in 2017 that limits the treaty benefit in inappropriate cases (Article 27A inserted by Notification No. SO 2680(E) {NO.68/2016 (F.No.500/3/2012-FTD-II)}, dated 10-8-2016, w.e.f. 1-4-2017). The LOB clause in Indo-Mauritius DTAC is an objective test that claims that any resident of the Contracting State shall not be entitled to any tax treaty benefits if the eco-

<sup>95</sup> Indo-US DTAC, 1990.

<sup>96</sup> Art. 24(2) of the Indo-US DTAC, 1990; Art. 24(3) of the Indo-Iceland DTAC, 2008; Art. 28(3) of the Indo-Tajikistan DTAC, 2009; Art. 28(3)(a) of the Indo-Armenia DTAC, 2004.

<sup>97</sup> Art. 24(3) of the Indo-Iceland DTAC, 2008; Art. 28(3) of the Indo-Tajikistan DTAC, 2009.

<sup>98</sup> Art. 28(3) (b) of the Indo-Armenia DTAC, 2004.

<sup>99</sup> Ibid, Art. 28(3) (c).

<sup>100</sup> Double Taxation Avoidance Agreements. In: *Indian Income Tax Department* [online]. 15. 6. 2020 [2021-01-31]. Available at: <<https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx>>.

<sup>101</sup> Annual Report. In: *Reserve Bank of India* [online]. 15. 6. 2020 [2021-01-31]. Available at: <<https://m.rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1278>>.

conomic affairs of the taxpayer are arranged only for the purpose of taking the advantage under Article 13(3B). Article 13 of the treaty deals with the allocation of taxing rights under Capital Gains and specifically regarding Sub-Article 13 B which state that “*Gains from the alienation of shares acquired on or after 1<sup>st</sup> April 2017 in a company which is resident of a Contracting State may be taxed in that State.*”

Further, in sub-article 2 of Article 27A restricts the use of shell/conduit companies to realize the benefits of the tax treaties under Article 13 (3B). Shell/Conduit companies are those legal entities falling within the purview of the definition of resident but having negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. The entities that have less expenditure less than Indian Rs. 2,700,000 or Mauritius Rs. 1,500,000 within immediately preceding 12 months from the date the gains arises in the respective Contracting State shall be categorized as deemed Shell/Conduit companies. However, entities that are listed on a recognized stock exchange of the Contracting State; or the expenditure done by the entities is over and above the threshold of Indian Rs. 2,700,000 or Mauritius Rs. 1,500,000 will not be considered as Shell/Conduit entities.<sup>102</sup>

Previously entities used the Indo-Mauritius DTAC for treaty shopping, as the Capital Gains Tax in Mauritius is nil.<sup>103</sup> However, when circular no. 789 dated 13-4-2000 issued by the Central Board of Direct Taxes (CBDT) was challenged and the Apex Court of India in *Union Of India And Anr vs Azadi Bachao Andolan And Anr* on 7 October 2003 ruled that tax avoidance is not illegal and for developing countries like India treaty shopping is a ‘necessary evil’ (*Union Of India And Anr vs Azadi Bachao Andolan*, [2003] 132 Taxman 373 (SC)).<sup>104</sup> However, after the 2008 economic slowdown, things have changed in the Geo-Political scenario and now the entire focus if the international community is on BEPS, 2015, report, and the contraventional Principal Purpose Test (PPT).

Concerning the Indo-Singapore DTAC, 1994, Article 24A that limits the benefits available in the tax treaty in inappropriate cases, that was inserted in 2017 (Article 24A inserted by Notification No. SO 935(E) [No.18/2017 (500/139/2002-FTD-II), dated 23-3-2017, w.e.f. 1-4-2017.]). The Article is divided into 5 sub-articles and the first 4 sub-articles are similar to the LOB clause of Indo-Mauritius, DTAC, 1984, the only difference is the threshold limit, which is S\$ 200,000 in Singapore or Indian Rs. 5,000,000 in India. The additional Art. 24A(5) which has defined the ‘recognized stock exchange’ that in the case of Singapore is Singapore Exchange Limited, Singapore Exchange Securities Trading Limited and The Central Depository (Pte) Limited, while in the case of India any stock exchange is recognized by the Securities and Exchange Board of India (SEBI). Except for this additional sub-article, the LOB clause in Indo-Mauritius DTAC and Indo-Singapore DTAC are similar

<sup>102</sup> Indo-Mauritius DTAC, 1984 – see Double Taxation Avoidance Agreements. In: *Indian Income Tax Department* [online]. 15. 6. 2020 [2021-01-31]. Available at: <<https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx>>.

<sup>103</sup> Deloitte. International Tax Mauritius Highlights 2019. In: *Deloitte* [online]. [2018-06-15]. Available at: <<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-mauritiushighlights-2020.pdf>>.

<sup>104</sup> *Union Of India And Anr vs Azadi Bachao Andolan*, 2003 132 Taxman 373 (SC).

which is a combination of the Special Anti-Avoidance Rule and the Principle Purpose Test. At the end of the LOB clause, there is an explanation added for further clarification, which says any legal entity which does not have bonafide business activities will be subject to sub-article 1 of the tax treaty restricting the treaty benefit.

Most of the DTAC of which India is a party are terminated and a Synthesised Text Of The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting (MLI) is implemented after the OECD's BEPS report in 2017. The list includes Australia, Austria, Belgium, Canada, Finland, Georgia, Ireland, Japan, Latvia, Lithuania, Luxembourg, Malta, Poland, Serbia, Singapore, Slovak, Slovenia, UAE, and the UK.

## CONCLUSION

After careful study of the methods used for limiting the benefits under the tax treaties, it is clear that drafters of LOB provisions need to strike a delicate balance between the prevention of avoidance and the safeguarding of legal certainty. Uncertainty may cause both an increase in avoidance and a decrease in FDI. It is, therefore, necessary that LOB clauses, and anti-abuse provisions in general, offer sufficiently clear taxpayer rules, so that it is possible to know in advance whether treaty benefits will be available for a certain transaction or not. India is a good example of tax avoidance practices; though the Developing world should understand that imposing an unnecessary burden on the taxpayer might affect investment. In the case of India for decades, Mauritius was the route for investment but after the incorporation of the LOB clause Mauritius gradually slip down from first place concerning FDI flow in India. However, there is no concrete evidence that why Mauritius has lost its place.

On the other front India has also passed General Anti-Avoidance Rules (GAAR) enforceable from 1 April 2018 (Section 95 of Income Tax Act, 1961). Therefore, India is trying to counter avoidance practices from both side Special Anti-Avoidance Rules in tax treaties and GAAR in domestic law.

On the other hand, and despite this need for certainty – the most pressing issue is arguably the need to ensure that there is a sufficient economic connection between the taxpayer and his claimed country of residence. This cannot be decided on purely formalistic grounds: the meaningfulness of the business must be assessed based on all facts and circumstances.<sup>105</sup>

Supreme Court of India in *Azadi Bacho Andolan* case viewed, “that if it was intended that a national of a third State should be precluded from the benefits of the DTAC, then a suitable term of limitation to that effect should have been incorporated therein. Article 24 of the Indo-U.S. DTAC is in marked contrast with the Indo-Mauritius DTAC. The appellants rightly contend that in the absence of a limitation clause, such as the one contained in Article 24 of the Indo-U.S. Treaty, there are no disabling or disintitling conditions under the Indo-Mauritius Treaty prohibiting the resident of a third nation from deriving

---

<sup>105</sup> BMMENS, N., DE BROE, L. Treaty Shopping and Avoidance of Abuse. In: M. Lang – P. Pistone et al. (eds.). *Tax Treaties: Building Bridges between Law and Economics*. IBFD, 2010, [2010-08-15]. Available at: <[http://www.ibfd.org/IBFD-Products/Tax-Treaties-Building-Bridges-between-Law-and-Economics#tab\\_2](http://www.ibfd.org/IBFD-Products/Tax-Treaties-Building-Bridges-between-Law-and-Economics#tab_2)>.

benefits thereunder.”<sup>106</sup> Supreme Court of India in Vodafone case, restrain themselves in doing interpretation through purposive construction of the word ‘indirect’ in Sec.9 (1) (i) of Income Tax Act, 1961 and laid down that the LOB clause is the policy matter of the government, either to use it in the tax statutes or the treaties. In both cases (Azadi & Vodafone cases) Supreme Court highlighted the lacuna in the treaties and legal provisions in question, which do not consist of any LOB provision, however, this does not mean that they have rejected the LOB clause as a useful means to check tax avoidance.

LOB article pattern adopted by India in entering into DTAC in the last decade is less restrictive and incorporates many of the U.N. suggestions for curtailing treaty shopping. Most significantly, the provision establishes a new method for allowing treaty benefits, the active business connection test. The inclusion of this subjective test represents a recognition that bona fide claimants might otherwise be discouraged from investing in the developing country out of a concern that treaty benefits will not be forthcoming. This concession is an important initial step in addressing the needs of developing countries).<sup>107</sup>

---

<sup>106</sup> Union of India v. Azadi Bachao Andolan, 2003 263ITR706(SC), para 104.

<sup>107</sup> Art. 28 of the Indo-Armenia DTAC, 2004; Art. 24 of the Indo-Iceland DTAC, 2008; Art. 28 of the Indo-United Mexican States DTAC, 2010; Art. 28 of the Indo-Tajikistan DTAC, 2009.