Prevention of Treaty Abuse

- Understanding India impact through select case studies

Vishal Gada

CTC Certificate Course on MLI

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dhruva

Overview of Article 7 of MLI – Prevention of Treaty Abuse

Prevention of Treaty Abuse – *Article 7…*

- **Principal Purpose Test (*PPT*):**

  A benefit under a treaty shall not be granted if it is ***reasonable to conclude***, having regard to all facts and circumstances that obtaining a tax benefit was the principal purpose or ***one of the principal purposes*** of an arrangement / transaction that led to the benefit

Impact on India:

- Article 7 is a minimum standard – the PPT will apply to all of India's covered tax agreements
- Provisions are similar to GAAR, but apply independently of Chapter X-A of the Income-tax Act, 1961 – Safeguards and exclusions under GAAR do not apply
- Will apply to all benefits that are claimed after the MLI comes into force *qua* a treaty – grandfathering not available

…Prevention of Treaty Abuse – Article 7

Simplified Limitation on Benefits (LOB):

- Can be implemented in addition to the PPT
- Under the Simplified LOB, treaty benefits are not available unless the resident is also a 'qualified person'. 'Qualified person' is defined to mean:

  - An individual, contracting state or its subdivisions, listed entities, NGOs, pension funds, entities whose shares are held by qualified persons for half the day sin a year, residents engaged in active trade or business, or entities which are more than 75% owned by equivalent beneficiaries

Impact on India:

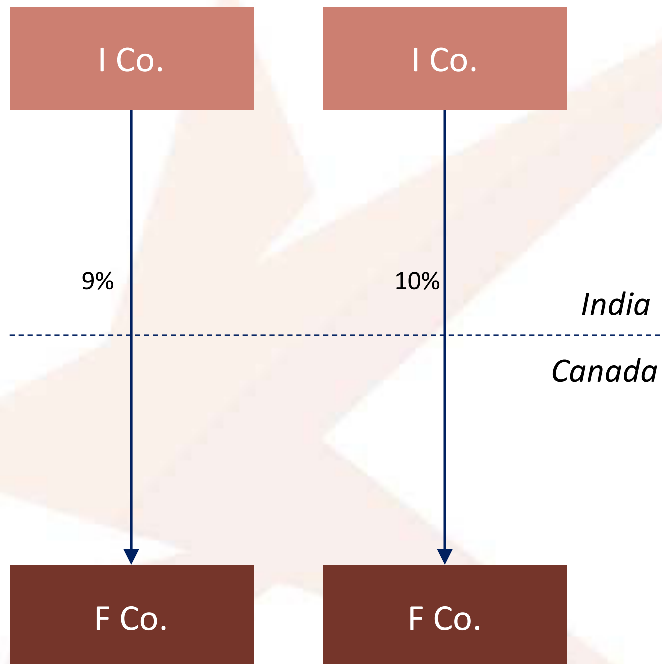
- This is not a minimum standard – India has chosen to apply Simplified LOB - will apply only if treaty partners have applied it
- Only the following 8 of India's treaty partners have opted for the simplified LOB - Armenia, Bulgaria, Colombia, Indonesia, Mexico, Russia, Slovak Republic and Uruguay

Case Studies

Case Study 1

Case Study 1

Benefit in accordance with object and purpose of treaty



Facts

- I Co., an Indian company, holds 9% equity shares in F Co., a company that is tax resident of Canada
- I Co. holds the said investment in F Co. since incorporation of F Co. viz. FY 2015-16
- Article 10 of India-Canada DTAA provides for withholding tax rate on dividend as under:
  - 15% provided the recipient of dividend is a beneficial owner being a company which controls directly or indirectly at least 10% equity shares in the company declaring dividends
  - 25% in all other cases
- Till last year, F Co. was in project stage and did not have any distributable profits
- It is envisaged that F Co. will start earning profits from current year
- I Co. increases its shareholding in F Co. from 9% to 10% during the current year

Issue for consideration

- Whether I Co. can be denied the benefit of lower tax withholding rate on dividend by contending that the increase in 1% shareholding was merely to avail benefit of treaty provisions?

Case Study 1

Benefit in accordance with object and purpose of treaty

- Paragraph 1 of Article 7 of MLI reads as under:

  Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that 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 object and purpose of the relevant provisions of the Covered Tax Agreement.

- Article 7(1) of MLI allows parties to a tax treaty to apply Principal Purpose Test ('PPT') to deny treaty benefit if obtaining such benefit was one of the principal purposes of any transaction entered into by a taxpayer

- However, such benefit not to be denied if it is established that granting the benefit would be in accordance with the object and purpose of relevant treaty provisions

Case Study 1

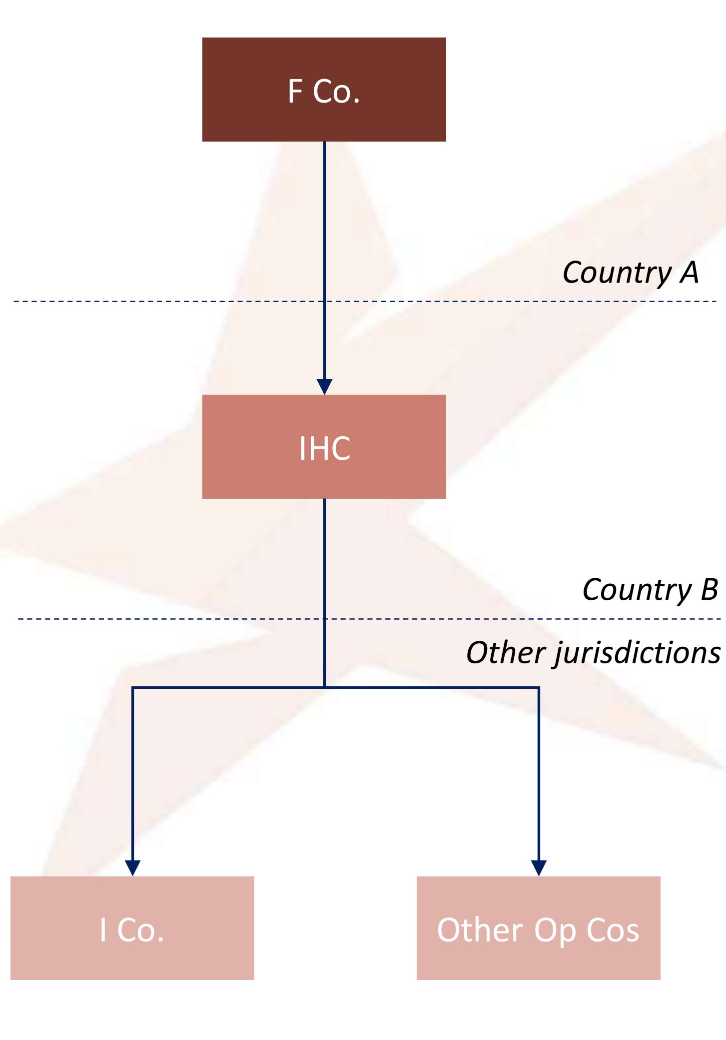
Benefit in accordance with object and purpose of treaty

- India-Canada DTAA to be regarded as a 'Covered Tax Agreement'
- Article 7(1) of MLI to apply and supersede the provisions of India-Canada DTAA to the extent the DTAA provisions are incompatible with Article 7(1)
- No specific provision in India-Canada DTAA with respect to denial of treaty benefit in case one of the principal purpose of a transaction is to avail such benefit – Article 7(1) of MLI to apply to India-Canada DTAA in entirety
- In the instant case, principal purpose of acquisition of additional 1% share is to avail benefit of lower withholding tax rate on dividend
- However, granting such benefit would be in accordance with the object and purpose of Article 10 of India-Canada DTAA
- Article 10(2)(a) of India-Canada DTAA provides for an arbitrary threshold of 10% for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends
- The same is consistent with the approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement
- I Co. should therefore not be denied benefit of lower withholding tax rate under India-Canada DTAA

Case Study 2

Case Study 2

Active Conduct of Business Test under SLOB



Facts

- F Co., an unlisted company being tax resident of Country A, acts a parent entity of ABC group of companies
- F Co. owns a manufacturing plant in Country A and also has a wholly owned unlisted subsidiary (IHC) in Country B
- IHC acts as an investment holding company for the Group
- IHC holds investments in various operating companies in different jurisdictions including I Co., an Indian company
- Considering the positions adopted by India and Country B under MLI, Simplified Limitation on Benefits Provision (SLOB) would apply in respect of India-Country B DTAA
- IHC does not meet the ownership criteria prescribed under SLOB clause for availing treaty benefit

Case Study 2

Active Conduct of Business Test under SLOB

Issues for consideration

- Whether IHC can avail the benefit of treaty between India and Country B under SLOB clause?
- Will the answer to above question differ if IHC is also engaged in providing financing and accounting services to the group entities?

Case Study 2

Active Conduct of Business Test under SLOB

- SLOB clause provides that a resident of a Contracting State shall be entitled to benefits of a tax treaty only if it meets any of the following conditions:

  a. The resident is a 'qualified person' – A resident is regarded as a qualified person if it is either an individual or a listed company or is owned by specified group of persons. Certain other categories have also been specified

  b. The resident is engaged in the active conduct of a business in its country of residence

  c. On at least half of the days of any 12-month period that includes the time when the benefit would otherwise be accorded, persons that are equivalent beneficiaries own, directly or indirectly, at least 75% of the beneficial interests of the resident

- IHC is not a listed company and also does not the ownership criteria prescribed under SLOB clause
- Pertinent to evaluate whether IHC is engaged in the active conduct of business in Country B

Case Study 2

Active Conduct of Business Test under SLOB

- Paragraph 10 of Article 7 provides that the term "active conduct of a business" *shall not include the following activities or any combination thereof*:

  a. operating as a holding company

  b. providing overall supervision or administration of a group of companies

  c. providing group financing (including cash pooling)

  d. making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such

- IHC acts as an investment holding company of the Group – as per Paragraph 10 of Article 7, IHC cannot be regarded to be engaged into active conduct of business

- Financing activity also does not qualify as 'active conduct of business'

- Even, where IHC provides centralised accounting services in addition to financing activity, such accounting services being in nature of administration of group companies, IHC should not be regarded as having satisfied active conduct of business test

Case Study 2

Active Conduct of Business Test under SLOB

- Indian courts have dealt with the issue of treaty benefits to investment holding company
- ***High Court of Andhra Pradesh*** in case of ***Sanofi Pasteur Holding SA vs Department of Revenue [2013] 354 ITR 316*** observed as under:

  "No curial or academic authority is placed on record to hazard a conclusion that a corporate entity must necessarily involve itself either in manufacture or marketing/trading in/of goods or services to qualify for the ascription of being in business or commerce. Creation of wholly owned subsidiaries or joint ventures either for domestic or overseas investment is a well established business/commercial organizational protocol; and investment is of itself a legitimate, established and globally well recognized business/commercial avocation.

  ShanH is a special purpose joint venture investment vehicle, established initially by MA and co-adopted in due course by GIMD and eventually by 'H', to facilitate investment by way of participation in the shareholding of SBL. That is the ShanH business and its commercial purpose."

- ***AAR*** in case of ***AB Holdings, Mauritius-II [2018] 402 ITR 37*** has held that setting up a subsidiary for purposes of investment cannot be questioned

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Case Study 2

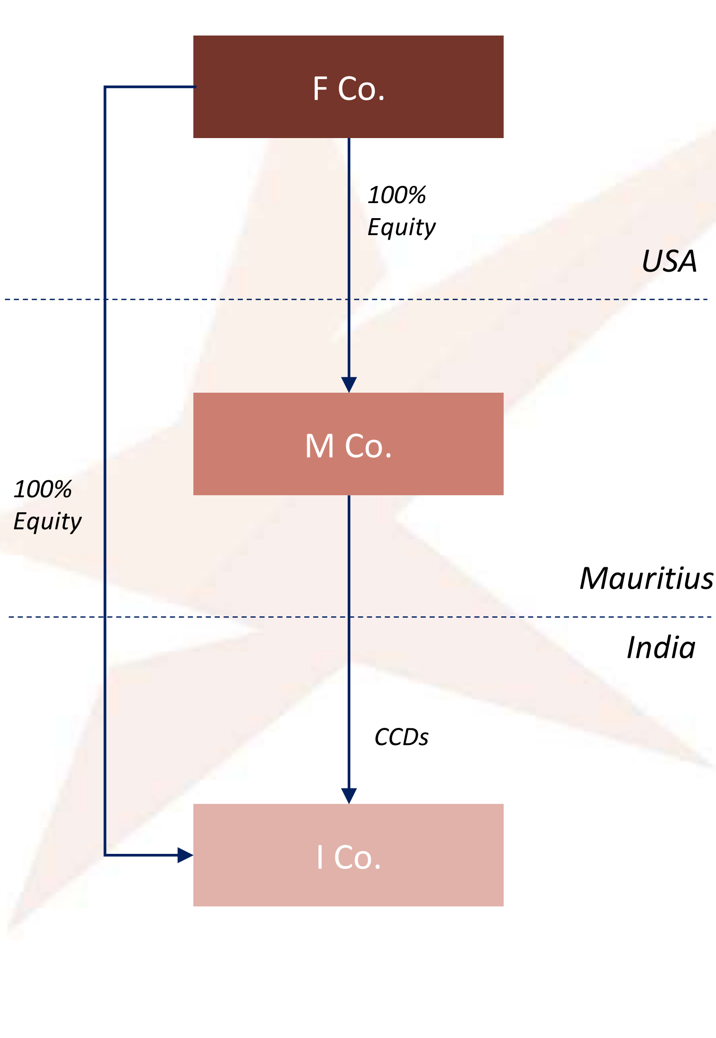
Active Conduct of Business Test under SLOB

- The above judicial precedents may no longer hold good if SLOB clause is incorporated in the treaty
- This is because SLOB clause specifically denies granting treaty benefits to an investment holding company, unless it meets the test of a 'qualified person'
- As on date, SLOB clause to form part of India's tax treaty with following countries after MLI provisions coming into effect:
  - Treaties where SLOB clause will apply in its entirety: Armenia,Russia, and Uruguay
  - Treaties where SLOB clause will apply and supersede the provisions of treaty to the extent of incompatibility: Bulgaria, Colombia, Indonesia, the Slovak Republic
  - Treaty where SLOB clause will apply asymmetrically by India: Greece (while Greece has not adopted SLOB clause, it has decided that India may apply SLOB clause to India-Greece DTAA)

Case Study 3

Case Study 3

GAAR vs. MLI



Facts

- F Co. is a company incorporated in USA and has a wholly owned subsidiary, I Co., in India
- F Co. proposes to infuse funds in I Co. in form of CCDs
- Considering the high rate of withholding tax of 15% on interest under India-USA DTAA, F Co. evaluates alternative jurisdictions for funding I Co.
- On comparison of treaty rates applicable vis-à-vis some of the identified jurisdictions, F Co. decides to infuse funds in I Co. through M Co., a Mauritius company
- India-Mauritius DTAA provides for withholding tax rate of 7.5% on interest
- As on date, Mauritius has not notified treaty with India that would be subject to MLI

Case Study 3

GAAR vs. MLI

Issues for consideration

- Considering that Mauritius has been selected as a jurisdiction for funding I Co. primarily on the basis on lower tax withholding rate under the treaty, whether treaty benefit can be denied to M Co. by invoking principal purpose test under MLI in the following cases:

  i. India-Mauritius DTAA is not amended in line with MLI provisions

  ii. India-Mauritius DTAA is amended in line with MLI provisions

- Whether the assessing officer can deny treaty benefit to M Co. by invoking GAAR under the provisions of the Income-tax Act, 1961?

- If the answer to above question is yes, whether the assessing officer has an option to deny treaty benefit to M Co. by applying principal purpose test under MLI (assuming treaty is amended in line with MLI) or by invoking GAAR? Or whether the assessing officer has to mandatorily follow the procedure stipulated under Chapter XA and deny treaty benefit by invoking GAAR?

Case Study 3

GAAR vs. MLI

<u>Denial of treaty benefit by invoking PPT when India-Mauritius DTAA is not amended in line with MLI</u>

- Currently, India-Mauritius DTAA does not qualify as a 'Covered Tax Agreement'
- Article 2 of MLI defines the term "Covered Tax Agreement" to mean an agreement for the avoidance of double taxation with respect to taxes on income (whether or not other taxes are also covered):
  a. that is in force between two or more jurisdictions; and
  b. with respect to which each such jurisdiction has made a notification to the Depositary listing the agreement as an agreement which it wishes to be covered by MLI
- While India has expressed its intention to cover Mauritius by MLI, Mauritius has not expressed its wish to cover India by MLI
- Accordingly, India-Mauritius DTAA not covered by MLI provisions as on date
- Till India-Mauritius DTAA is not covered by MLI, Principal Purpose Test specified under Article 7 of MLI cannot be invoked by either of the countries to deny treaty benefit

Case Study 3

GAAR vs. MLI

- However, even where India-Mauritius DTAA is not covered by MLI provisions, tax authorities may deny treaty benefit to M Co. if it is established that M Co. is not a beneficial owner of the interest income received from I Co.

- Article 11(2) of India-Mauritius DTAA reads as under:

  "However, subject to provisions of paragraphs 3, 3A and 4 of this Article, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 7.5 per cent of the gross amount of the interest."

- Where it is established that the beneficial owner of interest income is F Co. and M Co. has been interposed only to avail benefit of India-Mauritius DTAA, India may deny treaty benefit to M Co.

Concept of beneficial ownership discussed in next slide

Case Study 3

GAAR vs. MLI

- The term 'beneficial owner' is not defined in the treaty and may be interpreted as per the respective domestic laws of the State
- In determining the 'beneficial ownership', substance has to be seen over form
- A person is not a 'beneficial owner' of securities if, in spite of being a formal owner, he acts as conduit for another person who actually received the benefit of gains, dividend or interest from securities[1] [2]
- In order to challenge the 'beneficial ownership', there have to be indications of the fact that the legal owner's management is not in a position to make decisions differing from the will of its controlling shareholder or the activities of legal owner are so closely controlled and directed by the shareholder that legal owner can be regarded as merely an agent of its shareholders[2]
- A 'special purpose vehicle' may not qualify as the 'beneficial owner'[3]

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[1] Para 13 of UN Commentary (2011); Para 12.1 and 4.1 of the OECD Commentary (2010)
[2] KSPG Netherlands Holdings BV, In re (2010) 322 ITR 696 (AAR)
[3] IBFD Case No. Put-13602/PP/M.I/13/2008 (Tax Court of Indonesia)

Case Study 3

GAAR vs. MLI

- Supreme Court had upheld the validity of CBDT Circular No. 789 dated 13 April 2000 where is was clarified that Tax Residency Certificate (‘TRC’) would constitute the sufficient evidence for accepting the status of residence as well as beneficial ownership for granting treaty benefits[1]
- However, a TRC can be ignored where the transaction is fraudulent and against the national interest[2]
- Government approvals in country of source may evidence ‘beneficial ownership’ because the Government is not expected to approve an agreement without being satisfied that the taxpayer is the owner of the income as claimed in the agreement[3]

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[1] UOI v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)
[2] Vodafone International Holdings BV v. UOI (2012) 341 ITR 1 (SC)
[3] ADIT v. Universal International Music BV 2011-TII-22-ITAT-MUM-INTL

Case Study 3

GAAR vs. MLI

<u>Denial of treaty benefit by invoking PPT when India-Mauritius DTAA is amended in line with MLI</u>

- Assuming that India-Mauritius DTAA is subsequently covered by MLI, treaty benefit can be denied if it is reasonable to conclude that obtaining such benefit was one of the principal purpose of entering into an arrangement or transaction
  - Principal Purpose Test ('PPT') is a minimum standard under MLI and hence India-Mauritius DTAA would contain a PPT clause if the same is covered by MLI subsequently
- F Co. has set up a company in Mauritius solely with the purpose of availing benefit of lower tax withholding rate on interest under India-Mauritius DTAA
- It therefore becomes reasonable to conclude that obtaining the benefit of India-Mauritius DTAA was one of the principal purpose of infusing funds via Mauritius and hence Indian tax authorities can deny treaty benefit to M Co.
- Under PPT, imperative to ensure that a transaction has strong commercial rationale so as to avail treaty benefit

Case Study 3

GAAR vs. MLI

<u>Denial of treaty benefit by invoking GAAR under domestic law</u>

- Section 96 of the Income-tax Act, 1961 provides that an impermissible avoidance arrangement means an arrangement, *the main purpose of which is to obtain a tax benefit*, and it—
  a. creates rights or obligations which are not ordinarily created between persons dealing at arm's length;
  b. results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
  c. lacks commercial substance or is deemed to lack commercial substance under section 97; or
  d. is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes.
- Where a transaction is regarded as an impermissible avoidance arrangement, consequences mentioned in section 98 of the Act shall apply – one of the consequences is that the transaction shall be disregarded for tax purposes
- Further, section 90(2A) of the Act provides for treaty override – the provisions of GAAR shall apply even if they are not beneficial to the assessee
- In the instant case, the assessing officer may invoke GAAR by contending that the main purpose of infusing funds as CCDs via Mauritius was to obtain tax benefit (in form of lower tax rate under India-Mauritius DTAA) and that such transaction lacks commercial substance

Case Study 3

GAAR vs. MLI

- Option to assessing officer to deny treaty benefit by either invoking GAAR under domestic law or by invoking PPT under MLI

- While the Act provides for certain checks to ensure that GAAR provisions are not applied indiscriminately, no such provisions with respect to PPT under MLI

- The relevant paragraph from OECD Action Plan 6 on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances in this regard is reproduced below:

  "In a number of States, the application of the general anti-abuse rule found in domestic law is subject to some form of approval process. In some cases, the process provides for an internal acceleration of disputes on such provisions to senior officials in the administration. In other cases, the process allows for advisory panels to provide their views to the administration on the application of the rule. These types of approval processes reflect the serious nature of disputes in this area and promote overall consistency in the application of the rule. States may wish to establish a similar form of administrative process that would ensure that paragraph 7 is only applied after approval at a senior level within the administration."

Case Study 3

GAAR vs. MLI

- A comparative analysis for GAAR vis-à-vis PPT under MLI is provided below.

Particulars	**GAAR**	**PPT under MLI**
Purpose test	Can be invoked if main purpose of an arrangement is to obtain tax benefit	Can be invoked if one of the principal purposes is to obtain treaty benefit
Additional test to be satisfied	In addition to the purpose test, one of the four tainted element tests to be also satisfied	Only purpose test to be satisfied
Threshold	Applicable to an arrangement only where tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed Rs.3 crores	No such threshold prescribed
Grandfathering provisions	Yes	No
Procedure to be followed by tax authorities	Detailed procedure prescribed under the Act – Matter to be referred to an Approving Panel	No such procedure to be followed

Case Study 4

Case Study 4

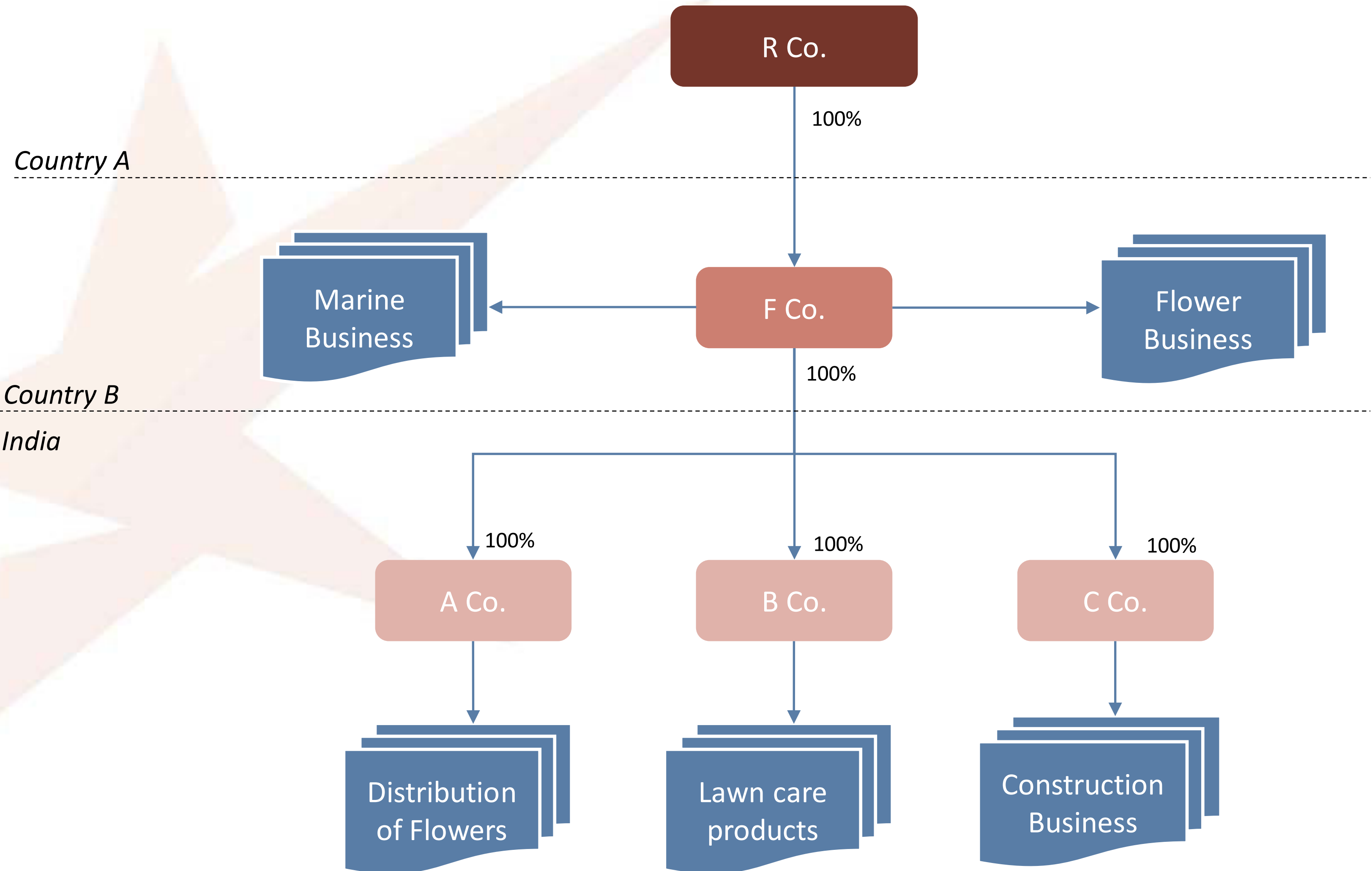
Active Conduct of Business Test under SLOB

Facts

- F Co., an unlisted company being tax resident of Country B, is held by a company (R Co.) which is tax resident of Country A
- F Co. produces and sells flowers across the world and is also into marine business. F Co. owns all the shares of 3 companies that are resident of India: A Co., B Co. and C Co.
- Businesses of A Co., B Co. and C Co. are as under:
    - A Co. distributes F Co.'s flowers in India under the trademark of F Co.;
    - B Co. markets a line of lawn care products in India.; and
    - C Co. is into construction business in India
- Considering the positions adopted by India and Country B under MLI, Simplified Limitation on Benefits Provision (SLOB) would apply in respect of India-Country B DTAA
- F Co. does not meet the ownership criteria as prescribed under para 9 of Article 7 of the MLI for availing treaty benefit. It is also provided that India-Country B DTAA is more favourable than India-Country A DTAA with respect to dividend withholding tax

Case Study 4

Active Conduct of Business Test under SLOB



Case Study 4

Active Conduct of Business Test under SLOB

Issues for consideration

- Will F Co. be eligible for the beneficial provisions of India-Country B DTAA for the income accruing from India from businesses activities of A Co., B Co. and C Co. considering the fact that F Co. has substantial business activities for flower business in Country B?
- Will the answer to above question differ if F Co. does not have substantial business activities for flower business due to:
  - **Situation 1**: Low market penetration of F Co. in spite of huge market for flowers in Country B?
  - **Situation 2**: Low market size of flower business in Country B as compared to India?
- If in case the business activities of A Co., B Co. and C Co. are carried on by a common Indian entity, then how will the provisions of SLOB be applied?

Case Study 4

Active Conduct of Business Test under SLOB

- Under SLOB provisions, even if the income recipient is not a 'Qualified Person' as defined in para 9 of Article 7 of the MLI, it may still be granted the treaty benefits if:
  - Income recipient is engaged in active conduct of business in its country of residence; and
  - Business activities for the income under consideration from the country of source are same or complementary to the business activities of the income recipient in the country of residence of the income recipient.

- Article 7 expressly provides that based on the facts and circumstances of the case, the business activities of the income recipient should be substantial in relation to the same activity or complimentary business activities in the country of source

Case Study 4

Active Conduct of Business Test under SLOB

Relevant Extracts

Para 10 of Article 7 of MLI:

"A resident of a Contracting Jurisdiction to a Covered Tax Agreement will be entitled to benefits of the Covered Tax Agreement with respect to an item of income derived from the other Contracting Jurisdiction, regardless of whether the resident is a qualified person, ***if the resident is engaged in the active conduct of a business in the first-mentioned Contracting Jurisdiction, and the income derived from the other Contracting Jurisdiction emanates from, or is incidental to, that business.****"*

"If a resident of a Contracting Jurisdiction to a Covered Tax Agreement derives an item of income from a business activity conducted by that resident in the other Contracting Jurisdiction, or derives an item of income arising in the other Contracting Jurisdiction from a connected person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item ***only if the business activity carried on by the resident in the first-mentioned Contracting Jurisdiction to which the item is related is substantial in relation to the same activity or a complementary business activity carried on by the resident or such connected person in the other Contracting Jurisdiction.*** *Whether a business activity is substantial for the purposes of this subparagraph shall be determined based on all the facts and circumstances."*

Case Study 4

Active Conduct of Business Test under SLOB

Clarification under BEPS Action Plan 6 for:

'same activity':

"50. A business activity generally will be considered to form part of a business activity conducted in the State of source ***if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services****. **The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source.** Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the business carried on in the State of source."*

'*complementary business activity*':

"51. For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but ***they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other****."*

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Case Study 4

Active Conduct of Business Test under SLOB

Clarification under BEPS Action Plan 6 for:

***'business'*:**

"47. The term "business" is not defined and, under the general rule of paragraph 2 of Article 3, must therefore be ***given the meaning that it has under domestic law****.* ***An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities."***

'substantial':

"54. The determination of substantiality is made based upon all the facts and circumstances and takes into account the ***comparative sizes of the businesses*** *in each Contracting State,* ***the nature of the activities performed*** *in each Contracting State, and the* ***relative contributions made to that business*** *in each Contracting State. In any case, in making each determination or comparison,* ***due regard will be given to the relative sizes of the economies and the markets in the two Contracting States****."*

Case Study 4

Active Conduct of Business Test under SLOB

- F Co., a tax resident of Country B, holds investments in A Co., B Co. and C Co., all three companies being tax residents of India
- A Co. is into the business of marketing and distribution of the products of F Co.
  - Such activity could be construed to be downstream business activity of F Co. and hence can be regarded as part of same activity as that of F Co.
- B Co. is into the business of marketing of lawn care products
  - While the products dealt with by B Co. are not produced or traded by F Co. the products of B Co. form part of the same overall industry
  - Business carried on by B Co. could thus be construed to be complementary to the business activities of F Co.
- C Co. is into construction business in India
  - Such activity is not connected to the business activities of F Co.

Case Study 4

Active Conduct of Business Test under SLOB

- Hence, *where F Co. has substantial business activities for flower business in its country of residence* i.e. in Country B –
  - Active business test parameters should be regarded as having been satisfied with respect to business activities of A Co. and B Co.
    - Accordingly the benefits of India-Country B DTAA should be available for incomes chargeable to tax in India in connection to business activities of A Co. and B Co.
  - Active business test parameters should not be regarded as having been satisfied with respect to business activities of C Co.
    - Accordingly the benefits of India-Country B DTAA may not be available for incomes chargeable to tax in India in connection to business activities of C Co.

What constitutes 'substantial business activities for flower business' ? – Discussion in next slide

Case Study 4

Active Conduct of Business Test under SLOB

- Substantiality criteria under active conduct of business test, *inter-alia*, requires to take into consideration the relative sizes of the economies and market in India and Country B for flower business
- If the business activities of F Co. for flower business in Country B are relatively low in spite of there being a huge market for flowers and its related products and services in Country B, then it may be construed that substantiality criteria is not met
  - Tax authorities may alleged that *de minimis* business activities in Country B are intentionally engaged to avail treaty benefits
  - In such cases, benefits of India-Country B DTAA may not be available for incomes chargeable to tax in India in connection with the business activities of A Co., B Co. and C Co.
- If the business activities of F Co. for flower business are low due to inadequate market for flowers and its related products and services in Country B, then it may be construed that substantiality criteria are met as it would be irrational to have substantial business activities where the market is narrow

Case Study 4

Active Conduct of Business Test under SLOB

- Pertinent to evaluate active conduct of business test where all the business activities conducted currently by A Co., B Co. and C Co. are carried out in a single entity in India

- How to determine whether a particular income stream flowing from Indian entity to F Co. is attributable to same/complementary business or to an unconnected business?

- Guidance available under Para 51 of BEPS Action Plan 6 on 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'

- For a case where more that one business is carried out through a single entity in the country of source and not all businesses satisfy the active conduct of business test, BEPS Action Plan 6 states that:

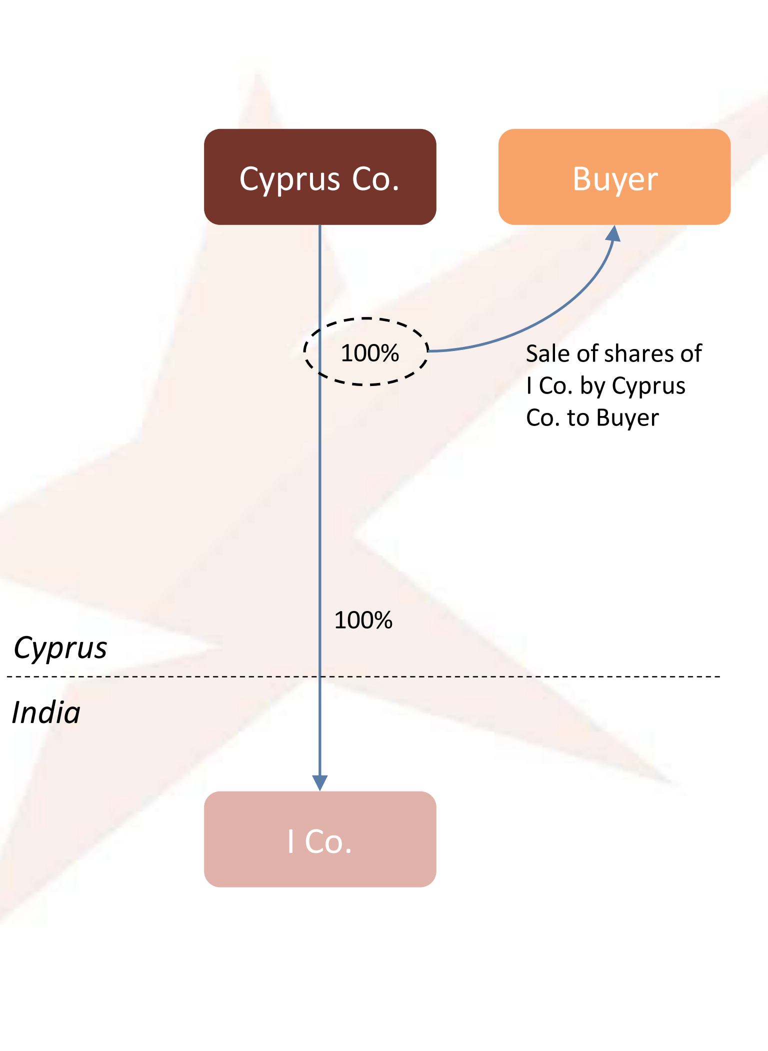
  "51. ….

  *Where more than one business is conducted in the State of source and only one of the businesses forms a part of or is complementary to a business conducted in the State of residence, **it is necessary to identify the business to which an item of income is attributable**. Royalties generally will be considered to be derived in connection with the business to which the underlying intangible property is attributable. **Dividends will be deemed to be derived first out of profits of the treaty-benefited business, and then out of other profits**. Interest income may be allocated under any reasonable method consistently applied."*

Case Study 5

Case Study 5

Principal Purpose Test and LOB clause



Facts

- Cyprus Co., a tax resident of Cyprus, holds 100% shares of I Co., an Indian company
- Cyprus Co. acquired shares of I Co. on 1 June 2016
- Cyprus Co. is an investment holding company without any significant business operations
- Cyprus Co. proposes to sell its 100% investment in I Co. to a buyer
- Considering the positions adopted by India and Cyprus under MLI, only Principal Purpose Test (PPT) to apply to India-Cyprus DTAA
  - SLOB clause not applicable

Case Study 5

Principal Purpose Test and LOB clause

Issues for consideration

- Cyprus Co. proposes to claim exemption in respect of capital gains arising on transfer of shares of I Co. under India-Cyprus DTAA and therefore intends to understand the following in context of Article 13 of India-Cyprus DTAA :
  - Whether Cyprus Co. can be denied treaty benefits under the Principal Purpose Test under MLI?
- If in the above case, the shareholder of I Co. is a resident of Singapore ('S Co.') instead of Cyprus –
  - Where S Co. fulfils the LOB conditions as provided in India-Singapore DTAA, can S Co. be still denied treaty benefits under the Principal Purpose Test under MLI?
  - Where S Co. fulfils the Principal Purpose Test but does not fulfil the LOB conditions as provided in the India-Singapore DTAA, can S Co. be still denied treaty benefits?

Case Study 5

Principal Purpose Test and LOB clause

<u>Scenario 1: Where shareholder of I Co. is a resident of Cyprus</u>

- Amended India-Cyprus DTAA provides for taxing rights to the country of source for the capital gains on transfer of shares [under Article 13(5)]
- However, pertinent to consider paragraph 2 of Protocol to India-Cyprus DTAA which reads as under: *"Notwithstanding anything in paragraphs 4 and 5 of Article 13 of the Agreement, gains from the alienation of shares that have been acquired at any time prior to the first day of April, 2017 shall be taxable only in the Contracting State of which the alienator is a resident."*
- Protocol to India-Cyprus DTAA thus provides for grandfathering the benefits in respect of capital gains on transfer of shares in specified circumstances
  - Taxing rights to be available only to country of residence of alienator if the shares that are being transferred were acquired before 1 April 2017
- Considering that Cyprus Co. had acquired shares of I Co. on 1 June 2016, in view of grandfathering provisions, capital gains arising to Cyprus Co. on transfer of shares of I Co. should not be taxable under India-Cyprus DTAA
- Pertinent to evaluate if such treaty benefit can be denied under MLI PPT by contending that the primary purpose of investment through Cyprus was to avail treaty benefit

Case Study 5

Principal Purpose Test and LOB clause

PPT under MLI

- Article 7(17)(a) of the MLI provides that where the Contracting Jurisdictions do not notify the existing article and paragraph of the Covered Tax Agreement that would be replaced by PPT under MLI, the PPT provisions of MLI shall supersede the provisions of the Covered Tax Agreement that are inconsistent to the PPT of MLI
- Since India and Cyprus have not made such notification under Article 7(17)(a) of the MLI, the PPT of MLI apply and shall supersede the similar provisions existing under the India-Cyprus DTAA, if any, to the extent of any inconsistency
- However, currently India-Cyprus DTAA does not contain any provision similar to PPT – hence, PPT as specified under MLI to apply to India-Cyprus DTAA in its entirety
- While MLI PPT would apply to India-Cyprus DTAA, pertinent to evaluate if MLI PPT would apply to a structure that is otherwise grandfathered under the DTAA – discussed in ensuing slides

Case Study 5

Principal Purpose Test and LOB clause

Grandfathering benefits under India-Cyprus DTAA

- ***Arguments in favour of taxpayer***
  - The facts and circumstances that prevailed at the time of implementation of the arrangement should be taken into account while determining the object and purpose of an arrangement
  - Preamble of the pre-MLI amended India-Cyprus DTAA expresses that one of the objective of entering into a treaty is to promoting economic cooperation between the two countries. In context of India-Mauritius DTAA, based on the similar preamble, Supreme Court in the case of *Azadi Bachao Andolan* read through the intent of the treaty and granted the treaty benefits to the taxpayer
  - Grandfathering provision of the treaty may be construed to fall within the exception provision (object and purpose of treaty) of PPT on the ground that the intention of the grandfathering provision was to avoid disorderly transition from resident based taxation to source based taxation for capital gains on shares under the India-Cyprus DTAA

Case Study 5

Principal Purpose Test and LOB clause

- ***Arguments against the taxpayer***
  - No grandfathering provisions under MLI – Article 7 is a non-obstante clause and hence will override even grandfathering provisions under India-Cyprus DTAA
  - Post MLI amended preamble of the India-Cyprus DTAA to not have additional language that encourages trade and investments between India and Cyprus
  - Paragraph 94 of Explanatory Statement to MLI suggests that narrower provisions of the treaties shall be replaced by the broader provision of PPT
  - Paragraph 7 and 10 of the Commentary on OECD Model Convention (pg. 56 of the BEPS Action Plan 6: 2015 Report) may be used against the taxpayer. Relevant extracts are as under:

    *“7. The term “benefit” includes all limitations …….. **It also includes limitations on the taxing rights of a Contracting State over a capital gain derived from the alienation of movable property located in that State by a resident of the other State under Article 13.** …..*

    ….

    *10. To determine whether or not one of the principal purposes of any person concerned with an arrangement or transaction is to obtain benefits under the Convention, **it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it**. What are the purposes of an arrangement or transaction is a question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case by case basis. ….”*

Case Study 5

Principal Purpose Test and LOB clause

Scenario 2: Where shareholder of I Co. is a resident of Singapore

- Protocol to the India-Singapore DTAA introduced vide Notification dated 23.03.2017 provides for taxing rights to the country of source for the capital gains on transfer of shares
- However, pertinent to consider Article 13(4A) of India-Singapore DTAA which reads as under:

  "Gains from the alienation of shares acquired before 1 April 2017 in a company which is a resident of a Contracting State shall be taxable only in the Contracting State in which the alienator is a resident."
- Article 13(4A) of India-Singapore DTAA thus provides for grandfathering the benefits for such capital gains in specified circumstances
  - Taxing rights to be available only to country of residence of alienator if the shares that are being transferred were acquired before 1 April 2017
- Considering that S Co. had acquired shares of I Co. on 1 June 2016, in view of grandfathering provisions, capital gains arising to S Co. on transfer of shares of I Co. should not be taxable under Article 13(4A) of India-Singapore DTAA
- Benefit under Article 13(4A) available subject to satisfaction of provisions mentioned in Article 24A – discussed in next slide

Case Study 5

Principal Purpose Test and LOB clause

- Grandfathering benefits under Article 13(4A) are subject to the Article 24A of the India-Singapore DTAA, which requires the taxpayer to fulfil 2 conditions – Purpose Test and Expenditure Test
  - Purpose Test ('Singapore PPT') is a subjective test that requires the taxpayer to substantiate that affairs were not arranged with the primary purpose to take the grandfathering benefits of the treaty
  - Expenditure Test is an objective test that requires the taxpayer incur an annual expenditure of at least SGD 200,000 in Singapore to justify that it is not a shell or conduit company

Case Study 5

Principal Purpose Test and LOB clause

PPT under MLI vis-à-vis Singapore PPT

- Article 7(17)(a) of the MLI provides that where the Contracting Jurisdictions do not notify the existing article and paragraph of the Covered Tax Agreement that would be replaced by PPT under MLI, the PPT provisions of MLI shall supersede the provisions of the Covered Tax Agreement that are inconsistent to the PPT under MLI
- Since India and Singapore have not made such notification under Article 7(17)(a) of the MLI, the PPT under MLI shall supersede the Singapore PPT, i.e., Article 24A(1) of the India-Singapore DTAA, to the extent provisions of Article 24A(1) of India-Singapore DTAA are incompatible with Article 7 of MLI
- Such overriding effect shall widen the existing narrower PPT under India-Singapore DTAA as the treaty only tests the 'primary purpose' and not 'one of the primary purpose' like MLI
- Pertinent to evaluate if treaty benefit can be denied by contending that investment in I Co through S Co was undertaken only to avail benefit of Article 13(4A) of India-Singapore DTAA
- Recently, Tax Court of Canada in case of Alta Energy SARL 2018 CC 152 (CanLII) allowed the benefit of Canada-Luxembourg DTAA to Luxembourg resident after evaluating if investment through Luxembourg could be denied on the grounds of tax avoidance – Key observations of the Court are stated in next slide

Case Study 5

Principal Purpose Test and LOB clause

- Key observations of Tax Court of Canada –

  "The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty, this statement remains vague regarding the application of specific articles of the Treaty. Under the GAAR analysis, the Court must identify the rationale underlying Article 1, 4 and 13, not a vague policy supporting a general approach to the interpretation of the Treaty as a whole."

  "There is nothing in the Treaty that suggests that a single purpose holding corporation, resident in Luxembourg, cannot avail itself of the benefits of the Treaty and that a holding corporation, resident in Luxembourg, should be denied the benefit of the Treaty because its shareholders are not themselves residents of Luxembourg."

- While MLI PPT would apply to India-Singapore DTAA, pertinent to evaluate if MLI PPT would apply to a structure that is otherwise grandfathered under the DTAA – arguments on similar lines as those discussed in case of India-Cyprus DTAA

- In addition to purpose test, expenditure test also needs consideration – discussed in ensuing slide

Case Study 5

Principal Purpose Test and LOB clause

Expenditure Test vis-à-vis PPT …

Applicability of expenditure test to be tested in each of the following scenarios:

1. Where it is held that MLI PPT should not apply in case of grandfathered investments
   - Expenditure test needs to be satisfied – specific provision under India-Singapore DTAA which stipulates that benefit of grandfathering available provided expenditure test is satisfied
2. Where it is held that MLI PPT should apply even in case of grandfathered investments
   - Imperative to evaluate whether expenditure test in such case would be an additional test to be satisfied or whether MLI PPT would supersede expenditure test prescribed under LOB clause in the DTAA
   - Also, it needs to be ascertained as to whether satisfaction of expenditure test would automatically imply satisfaction of MLI PPT or whether both tests need to be satisfied independently
   - The above aspects with respect to interplay between expenditure test and MLI PPT discussed in ensuing slides

Case Study 5

Principal Purpose Test and LOB clause

… Expenditure Test vis-à-vis PPT …

- Paragraph 95 of the Explanatory Statement to the MLI clarifies that where the treaty already contains any anti-abuse provision other than PPT, the PPT of MLI is not intended to restrict the scope or application of such existing anti-abuse rules
    - Hence, Expenditure Test under the treaty may not be superseded by the PPT of MLI as it is not incompatible as per Article 7(17)(a) of the MLI
- If the Expenditure Test of the treaty is not fulfilled, then entity shall deemed to be shell entity in terms of the LOB provisions of the India-Singapore DTAA and consequently the basic criteria for grandfathering benefits of the treaty is not satisfied
    - Hence, where the Expenditure Test for availing grandfathering benefits is not satisfied, it may be redundant to apply PPT

Case Study 5

Principal Purpose Test and LOB clause

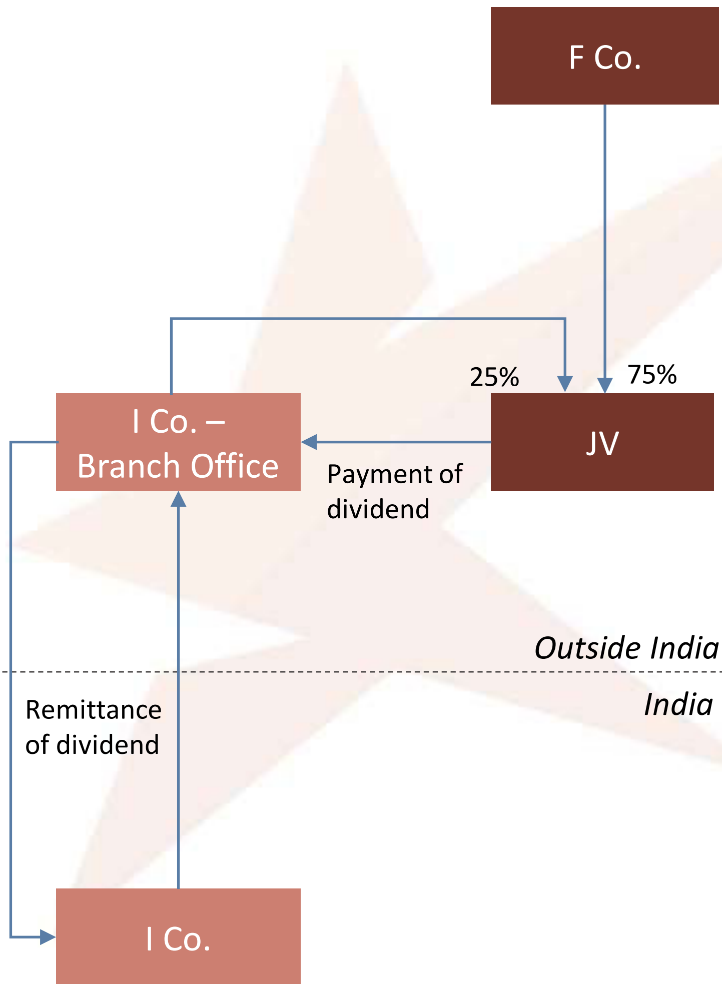
… Expenditure Test vis-à-vis PPT

- Irrespective whether the PPT is satisfied, fulfilment of the Expenditure Test under the treaty may grant the grandfathering benefits for the following reasons:
  - PPT under MLI provides for an exception that benefit may not be denied if it is established that granting the benefit would be in accordance with the object and purpose of relevant treaty provisions
  - If the Expenditure Test is read as the above exception provision of PPT, then the entity may be eligible grandfathering benefits on the analogy discussed in Case Study 1
  - An entity that fulfills the Expenditure Test may meet the PPT criteria as well because of the fact that the quantum of expenditure for the operations in Singapore may justify the active involvement of the entity in Singapore

Case Study 6

Case Study 6

Branch vs. Subsidiary



- I Co., an Indian company, entered into a JV with F Co., a foreign company, to form Fertilizer Company
- I Co. established a branch office in jurisdiction where JV is incorporated to oversee its investments in JV
- The branch office is independently registered as a company under the local laws of JV country. However, it claims permanent establishment ('PE') status as per tax treaty between India and JV Country
- Under the laws of JV country, dividend income received in the JV Country is exempt from tax
- Under tax treaty between India and JV country, dividend withholding tax rate is 10%
- Further, treaty provides for credit of taxes that would have been payable in JV country if the tax incentives were not granted
- I Co. has received dividend income from JV and claimed credit in respect of tax that would have been payable on that income if the incentive was not available in JV country

Case Study 6

Branch vs. Subsidiary

Issue for consideration

- Whether the Indian tax authorities can question the decision to set up a branch in place of subsidiary and deny treaty benefits to I Co. by invoking principal purpose test?

Case Study 6

Branch vs. Subsidiary

- Paragraph 1 of Article 7 of MLI reads as under:

  Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that 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 object and purpose of the relevant provisions of the Covered Tax Agreement.

- Article 7(1) of MLI allows parties to a tax treaty to apply Principal Purpose Test ('PPT') to deny treaty benefit if obtaining such benefit was one of the principal purposes of any transaction entered into by a taxpayer

Pertinent to evaluate whether setting up of branch by I Co. in JV Country results in any tax benefit under the treaty – discussion in ensuing slides

Case Study 6

Branch vs. Subsidiary

Benefit of setting up a branch instead of a subsidiary in the instant case

Effective tax outflow in case of formation of branch in JV Country

- As per the laws of JV Country, dividend income received by branch of I Co. in JV Country exempt from tax
- Dividend income received by branch of I Co. taxable in India – branch being extension of I Co., its income taxable in India
- However, considering the beneficial provision under India-JV Country DTAA, I Co. eligible for credit of tax that would have been payable in JV Country in absence of exemption provisions against Indian tax liability
- Thus, effectively, no tax outflow in India in respect of dividend income received by branch of I Co.

Case Study 6

Branch vs. Subsidiary

Effective tax outflow in case of formation of subsidiary in JV Country

- Dividend received by subsidiary of I Co. from JV Co. would be exempt from tax in JV Country due to incentives granted under domestic law of JV Country
- Dividend income received by the subsidiary to be subsequently repatriated to I Co. by way of dividend payment
- Such dividend payment to attract tax withholding by subsidiary @ 10%
- No exemption from such tax withholding since incentive available in JV Country only in respect of dividend income received in JV Country
  - In the instant case, dividend income to be received by I Co. in India i.e. outside JV Country
- Such dividend income received by I Co. taxable in India @ 15% as per section 115BBD of the income-tax Act
- I Co. eligible for credit of 10% withholding tax against 15% tax liability under section 115BBD of the Act
- Effective tax cost for I Co. in respect of dividend income from subsidiary: 15%
- Effective tax outflow for I Co. in India in respect of dividend income: 5%

Setting up of a branch favourable as compared to subsidiary from tax perspective due to beneficial treaty provisions

Case Study 6

Branch vs. Subsidiary

Denial of treaty benefit under Principal Purpose Test

Possible contentions by tax authorities

- Tax authorities may contend that the objective behind setting up a branch was to receive dividend income in JV Country and to take the advantage of not only local laws of JV Country but also to take benefit of deemed tax credit under India-JV Country DTAA
- If a subsidiary was formed instead of branch, I Co. would not have been eligible to avail deemed tax credit under the DTAA
- Further, in case of direct investment (without formation of subsidiary or branch), benefit for exemption on dividend income would not be available under local laws of JV Country as the same is granted only to a resident company or permanent establishment of the resident company in JV Country
- In case of direct investment too, deemed tax credit not available to I Co.
- Therefore, tax authority may allege that setting up a branch and registering the same as a company in JV Country has been done with an intent to avoid tax in India

Case Study 6

Branch vs. Subsidiary

<u>Denial of treaty benefit under Principal Purpose Test</u>

<u>Possible contentions by I Co.</u>

- Principal purpose of setting up branch in JV Country is to oversee investment of I Co. in JV Country and not to obtain treaty benefit
- Treaty benefit is only an incidental benefit available to I Co.
- Main objective of I Co. is to have a presence in JV Country
- Where formation of branch suffices the said objective, it cannot be mandated to have a subsidiary in JV Country instead of branch
- Tax authorities cannot dictate the manner of doing business – taxpayer has a choice to set up presence in the foreign country as per any of the possible legitimate options

Case Study 6

Branch vs. Subsidiary

<u>Denial of treaty benefit under Principal Purpose Test</u>

<u>Interplay of PPT with right of taxpayer to select method of implementation of a transaction</u>

- Under MLI PPT, treaty benefit can be denied if one of the principal purpose of entering into a transaction is to avail treaty benefit
- Can PPT interfere with taxpayer's right to implement a particular transaction in one of the alternate options available to it?
- No express guidance under BEPS Action Plan 6 or Explanatory Statement to MLI
- Reference may be made to CBDT Circular no. 7 of 2017 dated 27 January 2017 in the context of GAAR provisions under the Income-tax Act
  - FAQ no. 3 of the Circular states that GAAR will not interplay with the right of the taxpayer to select or choose the method of implementing a transaction
- Considering that both GAAR and PPT are in nature of anti-abuse provisions, possible to explore if a view may be taken that clarification under GAAR should hold good in the context of MLI as well

Case Study 7

Case Study 7

Selection of Jurisdiction

Facts

- I Co., an Indian company, is a wholly owned subsidiary of F Co., a tax resident of France
- F Co. has subscribed to CCDs of I Co. and receives interest income on CCDs from I Co.
- F Co. also provides certain technical services to I Co. for which I Co. is liable to pay fees to F Co. on an annual basis
- Considering high rate of tax in France, F Co. is evaluating receipt of income in low-tax jurisdictions in following manner:
  1. Formation of WOS in Ireland
     - Transfer of CCDs of I Co. by F Co. to Ireland Co.*
     - Interest to be paid by I Co. to Ireland Co. instead of F Co.
  2. Formation of WOS in UAE
     - Discontinuation of technical service agreement between I Co. and F Co.
     - Technical service agreement to be entered into between I Co. and UAE Co.
- Funds received from I Co. are proposed to be parked in Ireland and UAE for further overseas expansion
- Both India-France and India-Ireland provide for 10% withholding tax rate on interest
- While India-France DTAA provides for 10% withholding tax rate on FTS, India-UAE DTAA does not have article on FTS
- India-UAE and India-Ireland have agreed to incorporate principal purpose test in respective DTAAs

** (considering that there would not be significant time gap between subscription to CCDs and transfer of CCDs, F Co. does not envisage substantial capital gains tax liability)*

Case Study 7

Selection of Jurisdiction

Case Study 7

Selection of Jurisdiction

Issues for consideration

- Whether Indian tax authorities can disregard benefits under India – Ireland tax treaty in respect of interest income by invoking principal purpose test?
- Whether Indian tax authorities can disregard benefits under India – UAE tax treaty in respect of FTS by invoking principal purpose test?

Case Study 7

Selection of Jurisdiction

India-Ireland DTAA

- As per Article 7(1) of MLI, a benefit under a tax treaty can be denied if obtaining such benefit was one of the principal purposes of any transaction entered into by a taxpayer
- Pertinent to evaluate if one of principal purposes of interposing Ireland as a jurisdiction for receiving interest income from India is to avail benefit under India-Ireland DTAA
- Under both the tax treaties, viz. India-France DTAA and India-Ireland DTAA, interest income received by foreign company taxable in India @ 10%
- No preferential treatment available in respect of taxability of interest income under India-Ireland DTAA vis-à-vis India-France DTAA
- Main purpose of receiving interest income in Ireland is to avail the benefit of lower corporate tax rate in Ireland
- PPT under MLI can be invoked only if one of the main purpose of entering into a transaction is to avail benefit under a treaty
- Entering into a transaction with the main purpose being availing benefit of preferential tax regime of a particular jurisdiction cannot be the basis for denying treaty benefit under MLI
- However, recourse to benefit under India –Ireland DTTAA would still be subject to the requirement of beneficial owner test under Article 11 of India – Ireland DTAA – same as discussed in case study 3

Case Study 7

Selection of Jurisdiction

India-UAE DTAA

- Main purpose of receiving FTS in UAE is to avail the benefit of nil corporate tax rate in UAE as against high corporate tax rate in France
- Further, in absence of article on FTS in India-UAE DTAA, FTS received by UAE Co. should be regarded as business profits – in absence of PE of UAE Co. in India, such fees should not be taxable in India
- While main purpose of selecting UAE as a jurisdiction is to avail benefit of its domestic law, tax authorities may contend as under –
  - Had the fees been paid to F Co. (instead of UAE Co.), the same would have been taxable in India @ 10%
  - One of the principal purpose of having technical service agreement with UAE Co. is to avail benefit under India-UAE DTAA that was not otherwise available under India-France DTAA
- Pertinent to ensure that UAE Co. has adequate substance to justify receipt of FTS from I Co.

Contact us

Follow us on:

Mumbai
1101, One India Bulls Centre,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai - 400 013
Tel:+91-22-6108 1000 / 1900
Fax:+91-22-6108 1001

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate
Road,
Ahmedabad - 380 015
Tel: +91-79-6134 3434
Fax: +91-79-6134 3477

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560 001
Tel: +91-80-4660 2500
Fax: +91-80-4660 2501

Delhi / NCR
101 & 102, 1st Floor, Tower
4B, DLF Corporate Park,
M G Road, Gurgaon
Haryana - 122 002
Tel: +91-124-668 7000
Fax: +91-124-668 7001

Pune
305, Pride Gateway,
Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Dubai
WTS Dhruva Consultants
U-Bora Tower 2, 11th Floor,
Office 1101, Business Bay
P.O. Box 127165
Dubai, UAE
Tel: +971 56 900 5849

Bahrain
WTS Dhruva Consultants
Bahrain Financial Harbour,
East Tower - Floor 23, Office
2301, Building 1398, Road
4626, Block 346. Manama,
Kingdom of Bahrain
Tel: 973 1663 1921

Singapore
Dhruva Advisors (Singapore)
Pte.Ltd.
20 Collyer Quay,
#11-05, Singapore - 049319
Tel: +65 9105 3645

New York
Dhruva Advisors USA, Inc.
340 Madison Avenue,
19th Floor, New York,
New York 10173 USA
Tel: +1-212-220-9494

Silicon Valley, USA
Dhruva Advisors USA, Inc.
5201 Great America Parkway,
Santa Clara,
California 95054
Tel: +1 408 930 5063

Thank You

www.dhruvaadvisors.com

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