Prevention of Treaty Abuse

- Implementation & Beyond and Impact on Indian Treaties

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CTC MLI Course

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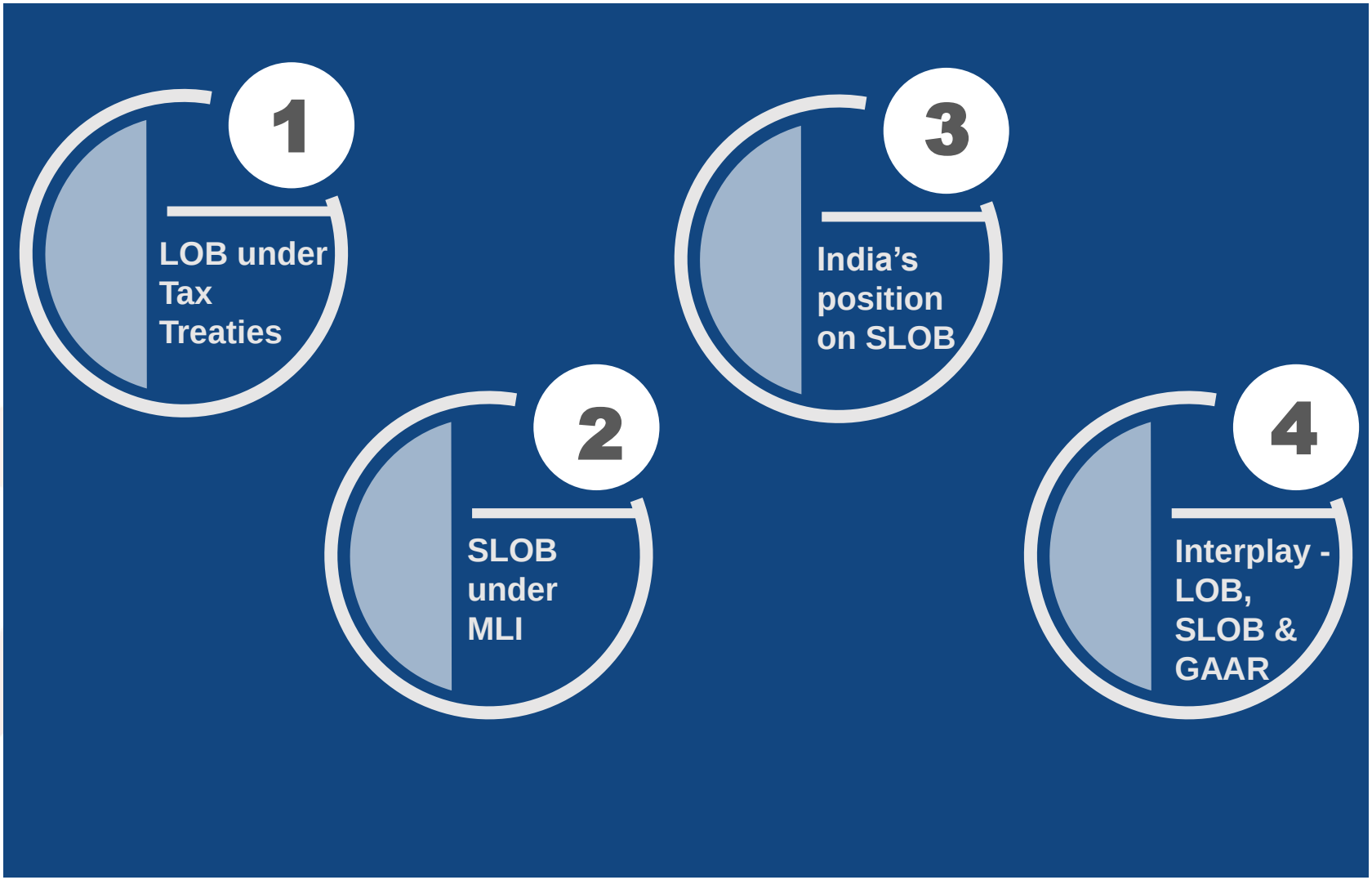
Agenda

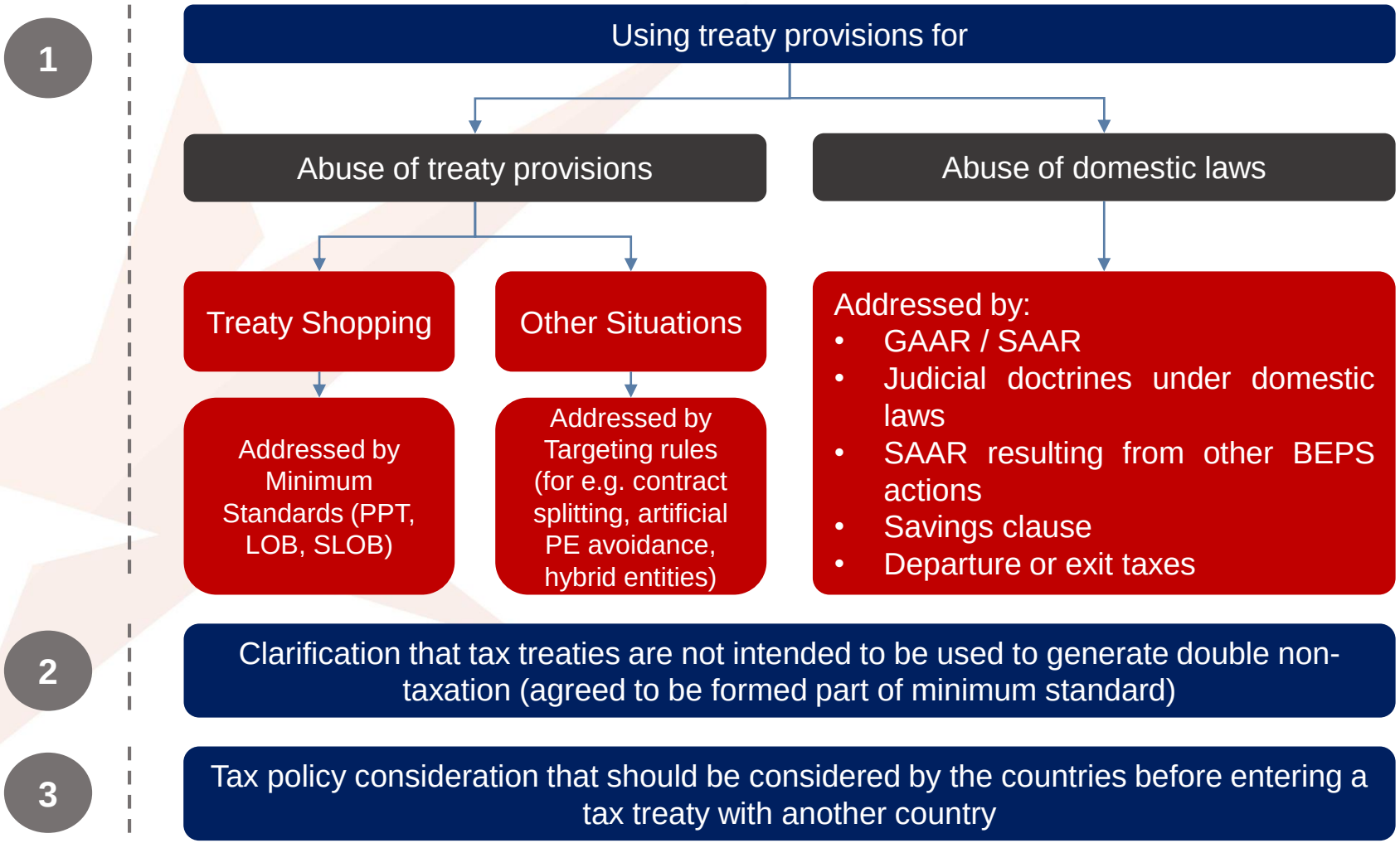

1
LOB under Tax Treaties
2
SLOB under MLI
3
India's position on SLOB
4
Interplay - LOB, SLOB & GAAR

What is Treaty Abuse?

Treaty abuse involves taking unintended benefits of the tax treaties through various tax avoidance strategies

1. Treaty Shopping
2. Splitting of contracts
3. Artificial avoidance of PE
4. Use of hybrid instruments, hybrid entities and hybrid transfers
5. Artificially arranging the value chain to minimize overall tax outflow

Measures to prevent treaty abuse



Overview of LOB under Tax Treaties

Concept of LOB provisions under Tax Treaties

- The term 'Limitation on Benefit' clause is generally not defined under Tax treaties.
  - Specific Articles, may not be titled as 'Limitation on Benefit', though in essence, outline various provisions of limiting treaty benefits

- LOB provisions has been explained in the OECD glossary on tax terms as:

  "Tax treaty provisions designed to restrict treaty-shopping opportunities by limiting treaty benefits to persons who meet one of several enumerated tests, which may require minimum level qualifications, e.g., local ownership.".

Forms of LOB provisions under tax treaties	
	Condition of 'beneficial ownership' to be satisfied by income recipient for certain categories of income such as dividend, interest, etc.
	'Subject to tax' condition under the broader 'liable to tax' condition vis-à-vis definition of tax resident
	Specific condition to be fulfilled vis-à-vis exemption from category of income. E.g. capital gains exemption condition under India-Singapore tax treaties
	Specific article on LOB dealing with conduit entities or treaty shopping or entities attempting to claim double non-taxation

Significance of LOB provision

- Significance of LOB clauses under tax treaties is evident from the ruling of SC in the case of ***Azadi Bachao Andolan*** on 'Treaty Shopping'
- Key observations of SC –
  - Developed countries tolerate and even encourage treaty shopping possibly for non-tax reasons like encouraging capital and technology inflows and the loss of tax revenues needs to be viewed in light of other non-tax benefits to the economy
  - ***Treaty shopping is not illegal*** but rather puts the ***onus on the Government to evaluate the policy considerations behind permitting or banning it***
  - SC drew this inference by noting the absence of LOB Clause in India-Mauritius DTAA in comparison to India-US DTAA – as evidence that if the test of residence was satisfied there was no bar on third country residents taking advantage of the treaty
  - In the Court's view, ***where the loss of tax revenue outweighs the non-tax benefits, the Government should renegotiate the tax treaties***
- US has a clear policy that it does not support treaty shopping and insists on including a LOB clause in all of its tax treaties
  - ***India-USA DTAA also has LOB clause – discussed in ensuing slides***

Basic Structure of LOB under Article 24 of India-US DTAA

Para	Test	Remarks
1.	Ownership Test and Base Erosion Test	An entity needs to satisfy both these tests in order to be eligible for treaty benefits – discussed in detail in next slide
2.	Active business connection test	This test is exception to Ownership Test and Base Erosion Test. Where entity does not satisfy both or any one of these tests but satisfies 'Active Business connection' test, then it would be eligible for treaty benefits
3.	Recognized Stock Exchange test	This test is exception to Ownership Test and Base Erosion Test. Where entity does not satisfy both or any one of these tests and also does not satisfy 'Active Business connection' test, but satisfies Recognized Stock Exchange test, then it would be eligible for treaty benefits
4.	Competent Authority test	It provides that where an entity is not eligible to treaty benefits due to non-satisfaction of above tests, the competent authority of the source state may still grant treaty benefit at its discretion

LOB provision under India-US DTAA

Ownership Test

More than 50% of beneficial interest in a non-corporate entity or more than 50% of number of shares of each class of shares is owned, directly or indirectly by:	Individuals, who are resident of India or US
	Govt. of India or US or its political sub-divisions or local authorities
	Other individuals subject to tax in India or US on their worldwide income
	Citizens of US

LOB provision under India-US DTAA

Base Erosion Test

- **This test requires that the income of the entity of country of source should not used in substantial part, directly or indirectly, to meet the liabilities (including liabilities of royalties or interest) of person who are not qualified persons**

Income	• As per US Treasury explanation to India-US DTAA, 'income' should be interpreted as 'gross income' under US Laws
Substantial	• As per the interpretation of US Treasury technical explanation, payments up to 50% or more of the income should be considered as 'substantial' • However, there could be scenario where lower percentage may be considered as substantial. For instance, the income recipient makes graded interest payments to the non-qualified person, which would be lower in the initial years and would increase in the future years
Meeting liabilities	• Payments vis-à-vis only profit & loss items to be considered • Where the income recipient repays the loan along with interest out of income received, the amount repaid towards interest should only be considered in the liabilities component while testing base erosion test

LOB clause under various Indian tax treaties

Sr. No.	Type of LOB Clause	Tax Treaty
1.	In line with US LOB clause i.e.: • Ownership Test • Active Business Test • Recognized Stock Exchange Test • Competent Authority Test	US, Armenia, Iceland, Tajikistan, Mexico
2.	Main purpose of arrangement is avoiding tax – anti-abuse test	Iceland, Tajikistan, Mexico, Mozambique, Kuwait, Luxembourg, Myanmar, UAE, Saudi Arabia, Syrian Arab Republic & UK
3.	Anti-abuse as well as competent authority test	Finland
4.	Domestic law overrides treaty in case of domestic anti-abuse provisions	Luxembourg Saudi Arabia
5.	Right to tax on foreign source income which is not taxable in other state	Namibia
6.	Income remittance test	Singapore

Overview of SLOB under BEPS Action 6 (Article 7 of MLI)

Overview of BEPS Action Report 6

- ***BEPS Action Plan 6 ('BEPS 6')*** is a detailed report on 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'
- Aims to address inappropriate granting of treaty benefits and potential treaty abuse strategies
- As a ***minimum standard***, it requires introduction of a ***title and preamble to tax treaties***
  - Clarifies the intent of the tax treaties and prevent their abuse
- Preamble under OECD Model Tax Convention reads as under –

  "PREAMBLE TO THE CONVENTION

  (State A) and (State B),

  Desiring to further develop their economic relationship and to enhance their co-operation in tax matters,

  Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital ***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 States),*

  – *Have agreed as follows:"*

Overview of BEPS Action Report 6

- BEPS Action Report 6 ***provides 3 alternative rules to address treaty abuse***
- As a minimum standard, it requires countries to ***implement at least one*** of the following anti-abuse measures in their tax treaties:
  - a Principal Purpose Test ***('PPT')*** only;
  - ***a PPT supplemented with*** either a simplified or a detailed Limitation Of Benefits ***('LOB')*** provision
  - a ***detailed LOB provision supplemented*** by a ***mutually negotiated mechanism*** to deal with conduit arrangements not already dealt with in tax treaties

The above 3 alternatives discussed in next slide

Overview of BEPS Action Report 6

PPT	• PPT provides that ***benefits*** under the tax treaty shall be ***denied*** if it is reasonable to conclude that ***obtaining the treaty benefit was one of the principal purposes*** of any arrangement • However, it provides a carve-out for granting such treaty benefits if it is in accordance with the object and purpose of the relevant provisions of the treaty
SLOB	• Simplified LOB provision ('SLOB') is an objective test to define the ***objective criteria*** that forms the basis of whether the person would qualify for the treaty benefits
Detailed LOB	• Detailed LOB provisions allows the Contracting Jurisdictions to ***agree on a detailed LOB provision*** instead of incorporating the default PPT as the subjective threshold governing grant of treaty benefits

Recommendations of BEPS 6 have been included under Article 6 and 7 of Multilateral Instrument ('MLI') as a mix of 'minimum standards' and 'optional provisions' to suitably amend the tax treaties

What is SLOB?

- SLOB is an ***objective test*** to determine whether the income recipient would qualify to avail treaty benefits
- **A person will qualify for treaty benefits only if it satisfies any of the following SLOB tests:**
  1. Income recipient is a ***Qualified Person ('QP')*** depending upon fulfilment of specified conditions
  2. Income recipient (not being a QP) meets the criterion of being ***owned by QP*** and hence becomes a ***deemed QP***
  3. Income recipient meets ***active conduct of business test***
  4. Income recipient meets the ***derivative benefits rule***
  5. Income recipient is granted ***discretionary relief by the competent authority*** (if none of the above conditions are met)

The above tests provided under SLOB clause discussed in detail in ensuing slides

SLOB Test 1: Qualified Person

SLOB

Test 1: Qualified Person

- A resident of another country, say Country A, (deriving income which is chargeable to tax in India) will qualify for tax treaty benefit if it fits within one of the following criterion:
  - ***Individual*** being a resident of Country A;
  - Country A, its ***political subdivisions***, local authorities, central bank, and entities that it wholly owns (such as, sovereign wealth funds);
  - ***Publicly-listed entities and their affiliates*** (provided that the conditions are met throughout the taxable period of the company or entity);
  - ***Charities and pension funds***

SLOB Test 2: Deemed Qualified Person

SLOB

Test 2: Deemed Qualified Person

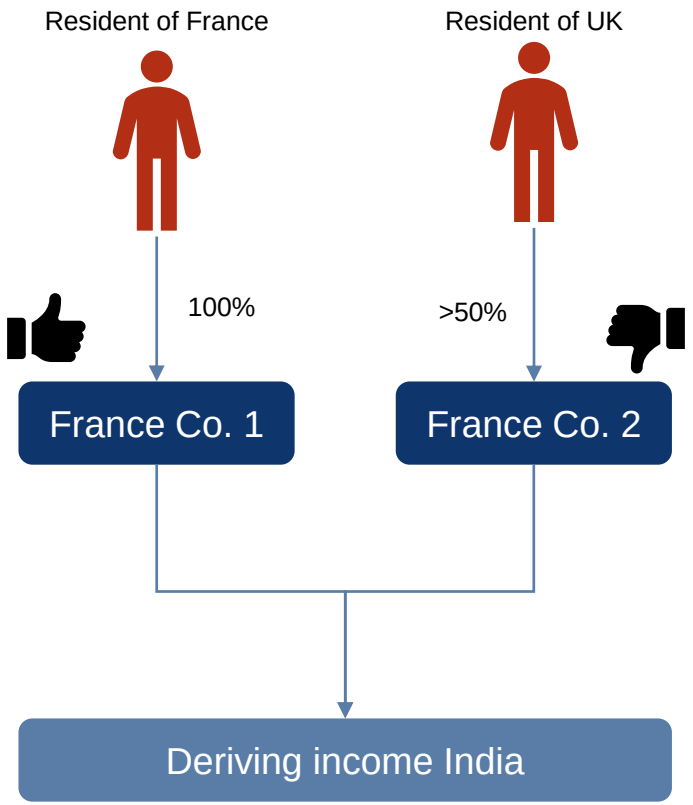
- Any entity resident of another country (deriving income which is chargeable to tax in India) will qualify for treaty benefit ***if at least 50% of the shares*** in that entity are ***owned, directly or indirectly, by one or more qualified persons***

- This test does not apply to individuals

- The ownership requirement ***should be met for at least half of the 12 months period*** that includes the time when treaty benefit is claimed by the income recipient

- The reference to shares includes comparable interests in entities other than companies

Determining treaty benefit entitlement for France Co under Deemed QP test



SLOB Test 3: Active Conduct of Business Test

SLOB

Test 3: Active Conduct of Business Test

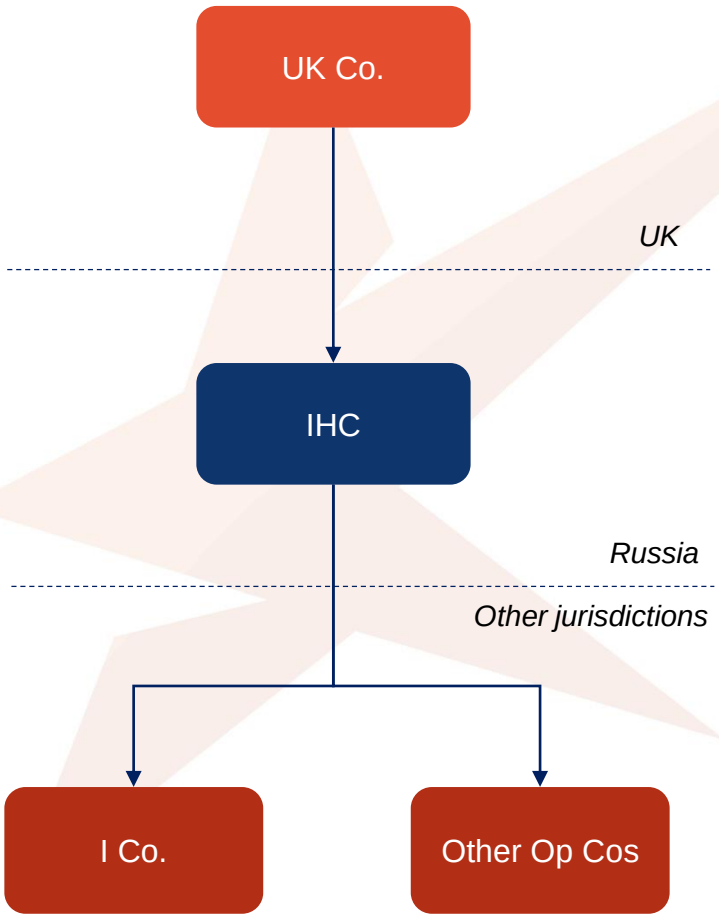
- Under SLOB provisions, even if the income recipient is not a 'Qualified Person' or 'Deemed Qualified Person', it may still be granted the treaty benefits if:
  - Income recipient is engaged in ***active conduct of business in its country of residence***; ***and***
  - Business activities for the income 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 of MLI 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

What constitutes active conduct of business – Discussed in case studies in ensuing slides

SLOB – Case Study 1

SLOB

Active Conduct of Business Test – Case Study 1



Facts

- UK Co., an unlisted company being tax resident of UK, is a parent entity of ABC group of companies
- UK Co. owns a manufacturing plant in UK and also has a wholly owned unlisted subsidiary (IHC) in Russia
- IHC acts as an investment holding company for the overseas operations of the Group
- IHC holds investments in various operating companies in different jurisdictions including I Co., an Indian company
- As per the positions adopted by India and Russia under MLI, SLOB provisions apply in respect of India-Russia DTAA
- IHC does not meet the ownership criteria prescribed under SLOB clause for availing treaty benefit

SLOB

Active Conduct of Business Test – Case Study 1

Issues for consideration

- Whether IHC can avail the benefit of treaty between India and Russia 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?

SLOB

Active Conduct of Business Test – Case Study 1

Testing each criterion 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

Sr. No.	Condition	Whether condition satisfied by IHC?
(1)	The resident is a 'qualified person' i.e. either an individual or a listed company or belongs to certain other prescribed category (like charities, political sub-division)	✗
(2)	50% shares of the resident are owned by person(s) referred to in (1) above	✗
(3)	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	✗
(4)	The resident is engaged in the active conduct of a business in its country of residence	To be tested – discussed in next slide

SLOB

Active Conduct of Business Test – Case Study 1

- Paragraph 10 of Article 7 of MLI 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

SLOB

Active Conduct of Business Test – Case Study 1

- 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***

SLOB

Active Conduct of Business Test – Case Study 1

- 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’

SLOB – Case Study 2

SLOB

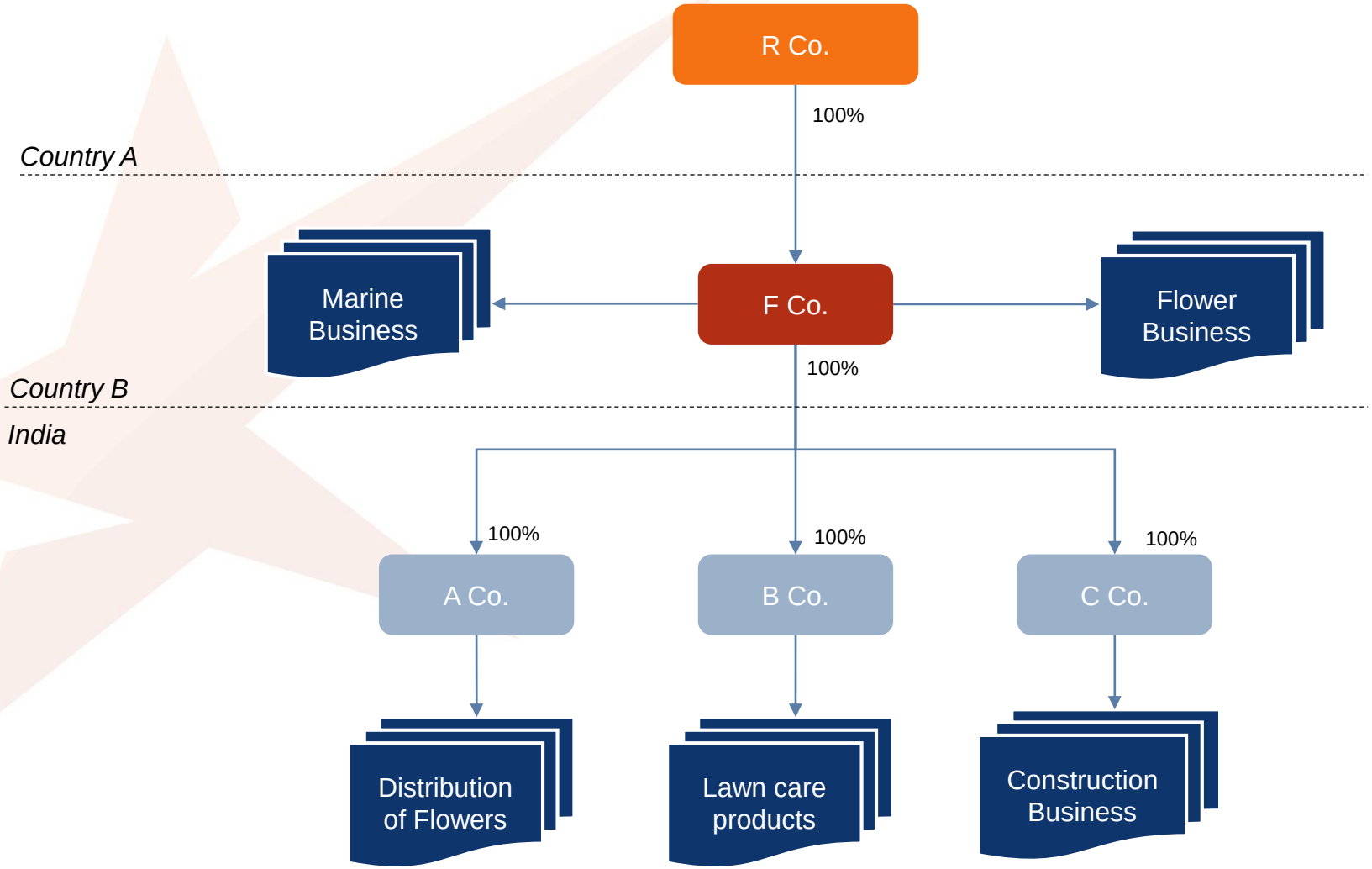
Active Conduct of Business Test – Case Study 2

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, SLOB Provision would apply in respect of India-Country B DTAA
- F Co. does not meet the ownership criteria as prescribed under Article 7(9) 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

SLOB

Active Conduct of Business Test – Case Study 2



SLOB

Active Conduct of Business Test – Case Study 2

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?

SLOB

Active Conduct of Business Test – Case Study 2

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."*

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Active Conduct of Business Test – Case Study 2

Relevant extract of BEPS Action Plan 6 in relation to active conduct of 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.***"

SLOB

Active Conduct of Business Test – Case Study 2

Clarification under BEPS Action Plan 6 on when an item of income can be said to be derived in connection with, or be incidental to, the business

"46. Subparagraph a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a business in that State may obtain the benefits of the Convention with respect to an item of income derived from the other Contracting State. ***The item of income, however, must be derived in connection with, or be incidental to, that business****."*

'Income in connection with the business'

"49. An item of income is derived in connection with a business if the income producing activity in the State of source is a line of business that ***"forms a part of" or is "complementary to" the business conducted in the State of residence by the income recipient****."*

What activity 'forms part of' or 'is complimentary to' the business conducted in State of residence of income recipient is discussed in next slide

SLOB

Active Conduct of Business Test – Case Study 2

Clarification under BEPS Action Plan 6 for:

'forms part of a business 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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Active Conduct of Business Test – Case Study 2

Clarification under BEPS Action Plan 6 on:

'Income is incidental to the business'

"52. An item of income derived from the State of source is "incidental to" the business carried on in the State of residence ***if production of the item facilitates the conduct of the business in the State of residence****. An example of incidental income is income derived from the temporary investment of working capital of a resident of one Contracting State."*

SLOB

Active Conduct of Business Test – Case Study 2

Clarification under BEPS Action Plan 6 for:

'substantial'

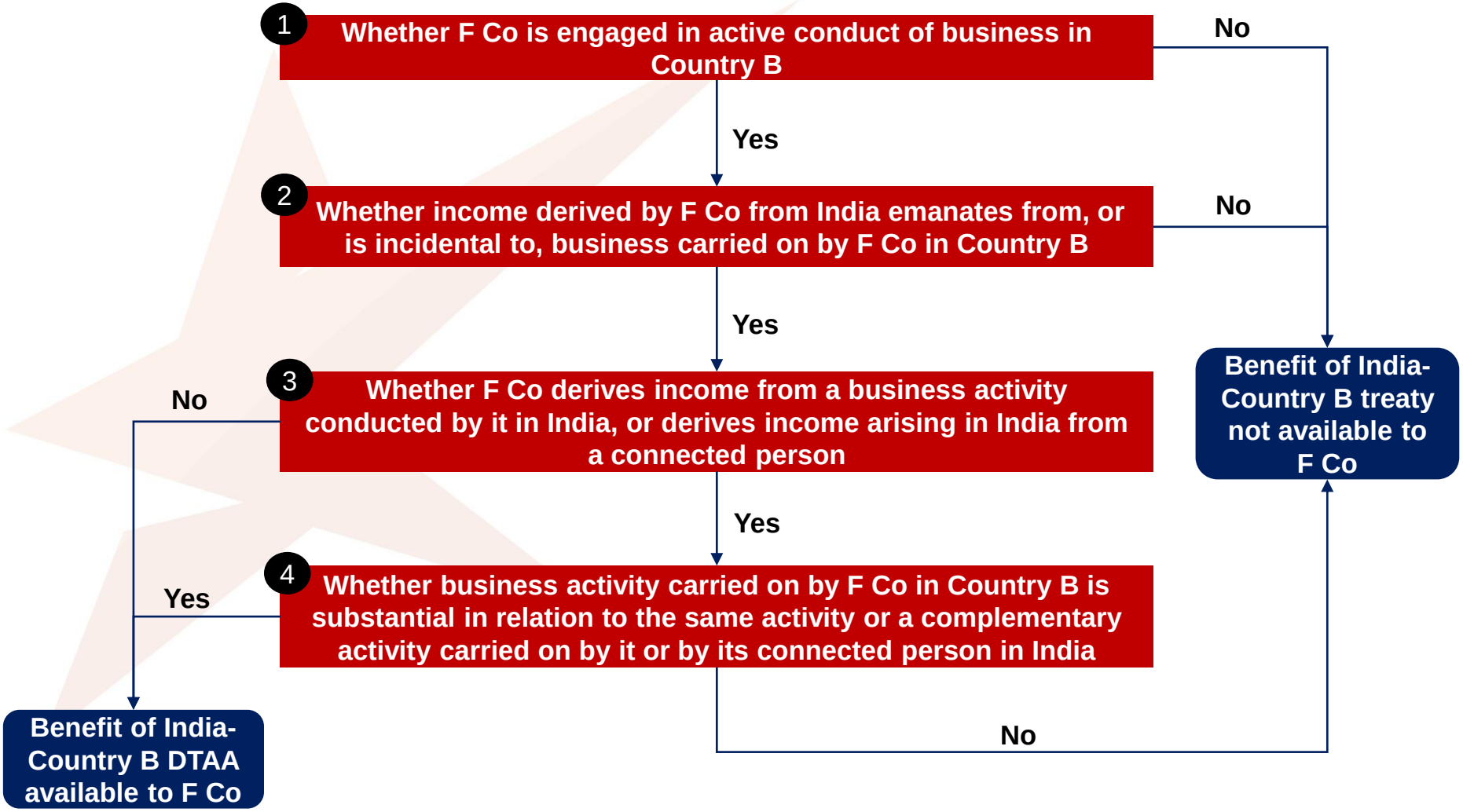
"54. The determination of substantiality is made based upon all the facts and circumstances and takes into account the ***comparative sizes of the businesses*** *in each Contracting State,* ***the nature of the activities performed*** *in each Contracting State, and the* ***relative contributions made 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****."*

'connected person'

"43. … A person shall be connected to another if one possesses at least ***50 per cent of the beneficial interest in the other*** *(or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances,* ***one has control of the other or both are under the control of the same person or persons****."*

SLOB

Active Conduct of Business Test – Case Study 2



SLOB

Active Conduct of Business Test – Case Study 2

Step 1: Whether F Co is engaged in active conduct of business in Country B

- F Co., a tax resident of Country B, is engaged in flower business and marine business
- F Co to be considered to be engaged in active conduct of business provided the persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities

SLOB

Active Conduct of Business Test – Case Study 2

Step 2: Whether income derived by F Co from India emanates from, or is incidental to, business carried on by F Co in Country B …

- 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.

SLOB

Active Conduct of Business Test – Case Study 2

… Step 2: Whether income derived by F Co from India emanates from, or is incidental to, business carried on by F Co in Country B

- Income derived by F Co from C Co cannot be said to be derived in connection with or incidental to business conducted by F Co in Country B
  - 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
- Income derived by F Co from A Co and B Co is derived in connection with or incidental to business conducted by F Co in Country B
  - Step 3 and 4 to be tested for income derived from A Co and B Co by F Co to determine treaty entitlement

SLOB

Active Conduct of Business Test – Case Study 2

Step 3: Whether F Co derives income from a business activity conducted by it in India, or derives income arising in India from a connected person

- F Co derives income from A Co and B Co which are wholly owned subsidiaries of F Co
- A Co and B Co to be considered as connected persons for F Co
- F Co thus derives income from India from its connected persons

SLOB

Active Conduct of Business Test – Case Study 2

Step 4: Whether business activity carried on by F Co in Country B is substantial in relation to the same activity or a complementary activity carried on by it or by its connected person in India

- As discussed in Step 3, income earned by F Co. from India is derived from its connected persons viz. A Co. and B Co.
- As a final step, imperative to evaluate if business activity carried on by F Co. in Country B is substantial in relation to same activity or complementary activity carried on by its connected persons (being A Co. and B Co.) in India
- 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 to F Co. for incomes derived from A Co. and B Co. which are chargeable to tax in India

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

SLOB

Active Conduct of Business Test – Case Study 2

- ***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. and B 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

SLOB

Active Conduct of Business Test – Case Study 2

Evaluating 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 than 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. ….

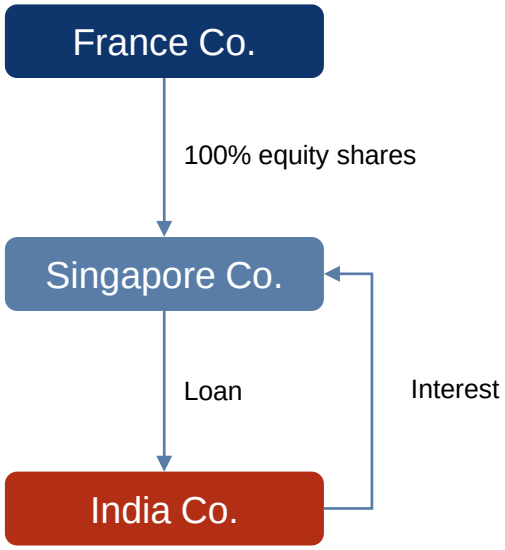
  Where more than one business is conducted in the State of source and only one of the businesses forms a part of or is complementary to a business conducted in the State of residence, ***it is necessary to identify the business to which an item of income is attributable****. Royalties generally will be 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."*

SLOB Test 4: Derivative Benefit Rule

SLOB

Test 4: Derivative Benefit Rules

- It is based on concept of "equivalent beneficiary" (EB) test
- It is to rule out those cases where there is no apparent risk of treaty shopping, because, the ultimate owner of the income recipient entity is based out of a jurisdiction that grants a more favorable or similar treaty benefit to income derived from source country, as compared to the jurisdiction in which the income recipient entity is situated
- The treaty benefit is granted if, at least 75% of the actual income recipient is owned, directly or indirectly, by EB
- This condition should be met during at least half of any 12-month period in which the treaty benefit is claimed



WHT on Interest under DTAA

India-Singapore DTAA – 15%
India-France DTAA – 10%

India has reserved its right to grant tax treaty benefits under derivative benefit test to an entity only where it is directly held by EB

SLOB Test 5: Discretionary Relief by Competent Authority

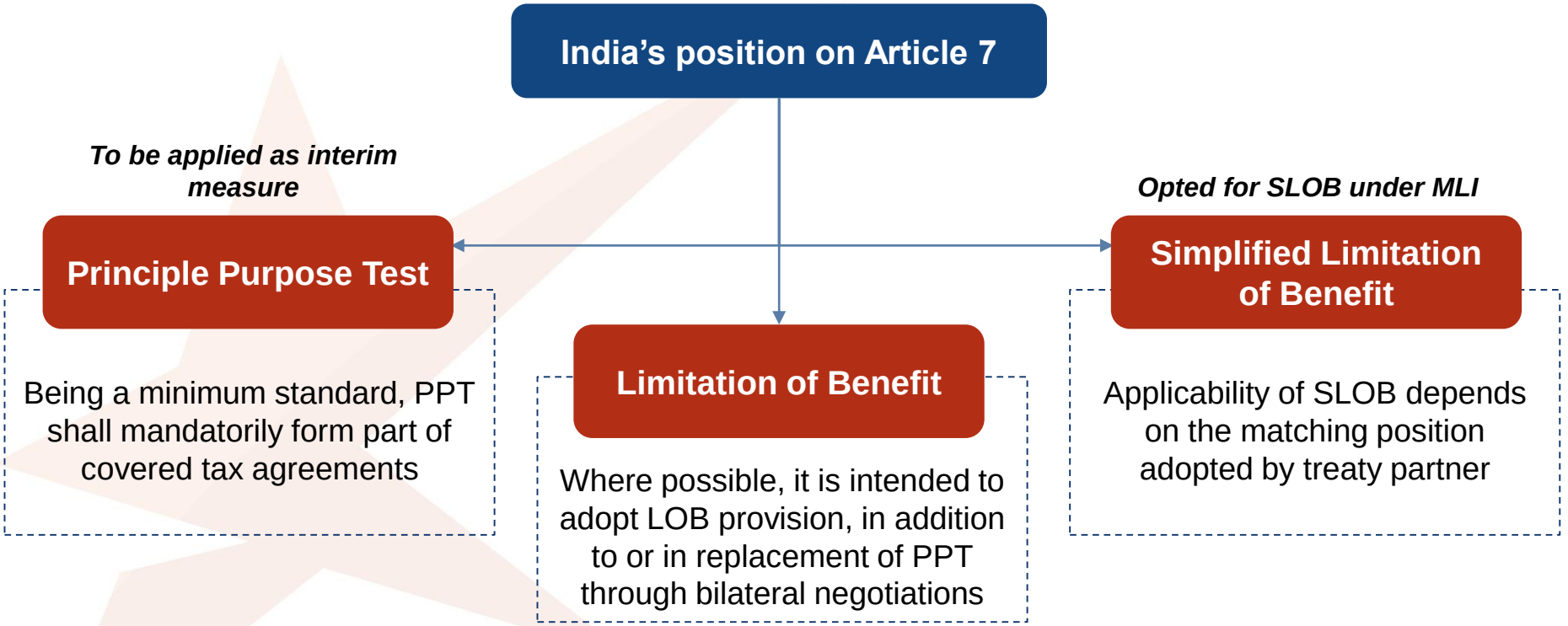
SLOB

Test 5: Discretionary relief by Competent Authority

- Considering the object and purpose of the tax treaty, Competent Authority, at its discretion, is empowered to grant treaty relief to an income recipient when such person would be denied treaty benefits applying the objective tests under the SLOB provisions
- Such discretionary relief may be granted only if the resident has demonstrated to the satisfaction of the Competent Authority that, neither the resident's establishment, acquisition or maintenance, nor the conduct of the resident's operations, had one of the principal purposes of obtaining benefit under the tax treaty
- Provision for discretionary relief in SLOB is not an optional provision and is an integral part of SLOB provisions. It is not akin to discretionary relief in PPT that is optional for a signatory to MLI

India’s position on SLOB

India's position



India has accepted to apply PPT as an interim measure and intends where possible to adopt LoB provision, in addition or replacement of PPT, through bilateral negotiations along with Simplified LoB

Detailed discussion on matching concept for SLOB in ensuing slides

Matching concept under SLOB

Sr. No.	State A	State B	Impact on A-B tax treaty
1.	Opted for SLOB	Country B is not signatory to MLI	MLI is applicable only when both the countries are signatories to MLI Albania, Sri Lanka, Tajikistan, Tanzania and USA have not signed the MLI yet and hence MLI does not apply to tax treaties with such countries
2.	Opted for SLOB	Treaty with State A is not included in State B's list of treaties to be modified by MLI	MLI can apply only when both the parties to a tax treaty have notified their intent to cover A-B tax treaty under MLI Mauritius has not notified its treaty with India to form part of MLI and accordingly, India and Mauritius will need to bilaterally negotiate the terms to ensure compliance with minimum standards
3.	Opted for SLOB	Opted for SLOB	SLOB will apply to A-B tax treaty In addition to India, 11 other jurisdictions have opted for SLOB rule - namely Argentina, Armenia, Bulgaria, Chile, Colombia, Indonesia, Mexico, Russia, Senegal, Slovakia and Uruguay

Matching concept under SLOB

Sr. No.	State A	State B	Impact on A-B tax treaty
4.	Opted for SLOB	Not opted for SLOB	Application of SLOB to A-B tax treaty to depend on the approach adopted by State B – Detailed discussion in next slide

Matching concept under SLOB

Symmetrical Approach

- Where State B exercises symmetrical application of SLOB [Article 7(a)]
  - both State B as well as State A would apply both PPT as well as SLOB in determining whether to grant the treaty benefits

Asymmetrical Approach

- Where State B exercises asymmetrical application of SLOB [Article 7(b)]
  - State A (having opted for SLOB) may deny benefits under A-B tax treaty by applying PPT as well as SLOB
  - State B will apply only PPT as an anti-abuse measure

Failure by State B to opt for either of the above options may result in State A to opt out of application of whole of Article 7. Thereby, both States shall bilaterally negotiate to meet the minimum standards

Matching concept under SLOB

Symmetrical application	• Denmark, Norway and Iceland have opted for symmetrical application of SLOB in context of Indian tax treaties
Asymmetrical application	• Greece has opted for asymmetrical application of SLOB such that - Greece will merely test PPT rule when treaty benefit is evaluated in favour of residents of India - India has flexibility to apply the stricter norm of PPT and SLOB as permissible norms while extending treaty benefit to a resident of Greece
Mutual agreement to meet minimum standard	• Netherlands, Cyprus, Australia, Luxembourg, Sweden have not opted for SLOB and have also not chosen for symmetrical or asymmetrical application of SLOB with India under Article 7(7) - Per Article 7(16), countries shall endeavour to reach a mutually satisfactory solution which meets the minimum standard for preventing treaty abuse

Most of India's treaty partners have chosen not to allow an asymmetric application of SLOB, thereby resulting in application of only a PPT to tax treaties

Interaction of SLOB with existing LOB

Interaction of SLOB with existing LOB

India's treaty partners that have opted for SLOB

SLOB to override existing LOB	**Armenia Uruguay**	• India, Armenia and Uruguay have notified each other under Article 7(17)(c) and hence existing LOB provision to be replaced by the SLOB by application of Article 7(17)(e)
Existing LOB to prevail over SLOB	**Mexico**	• Under Article 7(15)(c), Mexico, *inter alia*, has notified India reserving the right not to apply SLOB to India-Mexico DTAA already containing LOB provisions
SLOB to override existing LOB to the extent incompatible	**Argentina Bulgaria Colombia Indonesia Russia Slovakia**	• These countriies have <u>not</u> notified each other (incl. India) under Article 7(17)(c), hence SLOB to override existing LOB only to the extent incompatible

Interaction of SLOB with existing LOB

India's treaty partners that have NOT opted for SLOB

Existing LOB to continue to apply and to prevail over SLOB

Singapore
Spain

- Specific LOB clause under the respective tax treaties with India
- Singapore and Spain have not chosen for symmetrical or asymmetrical application of SLOB with India under Article 7(7)
  - SLOB not to have any impact on the existing tax treaty
  - Existing LOB conditions would continue to apply

Interplay of LOB / SLOB with GAAR

Interplay of LOB / SLOB with GAAR

Particulars	LOB / SLOB	GAAR
Applicability	Specific Anti-Avoidance Rule triggered based on objective criterion viz. legal nature, ownership, activities performed	Triggered when main purpose is tax benefit along with presence of one of the tainted element tests – subjective test to determine tax avoidance
Scope	Primarily to counteract against abuse by way of treaty shopping	Has wide reach to prevent complex conduit transactions and abusive arrangements including treaty shopping
Consequences	LOB / SLOB has limited impact in form of denial of treaty benefit	GAAR has wider reach from re-characterizing a transaction to re-allocation of income (including denial of treaty benefit)
Grandfathering provisions	No grandfathering provisions	Grandfathering available to investments made before 1 April 2017
De-minimis threshold	No minimum threshold for applicability of SLOB	GAAR does not apply where the tax benefit in a financial year does not exceed Rs. 3 crores

Interplay of LOB / SLOB with GAAR

Amendment in Indian tax law

- Unilateral power provided under the Indian tax law for application of GAAR provisions even in case where treaty provisions are more beneficial [Section 90(2A)]
  - Whether this breaches the principles of ***pacta sunt servanda*** (agreements must be kept) incorporated in Article 26 of the Vienna Convention on the Law of Treaties, 1969?

CBDT Clarification[1]

- CBDT is of the view of that adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies
- If tax avoidance is 'sufficiently addressed' by LOB in the treaty, GAAR may not be invoked
  - Meaning and threshold of term '**sufficiently addressed**' is unclear and subjective

[1]Circular No. 7 of 2017 dated 27-1-2017

Interplay of LOB / SLOB with GAAR

Commentary on OECD MC 2017

- Para 77 of Commentary to OECD Model Convention 2017, *inter alia*, provides that there exists no conflict between the provisions of tax treaty and domestic GAAR if the provisions of domestic GAAR are formulated in line with the principle of PPT
- In the Indian scenario, PPT Rule to be incorporated in tax treaties through MLI as a minimum standard has wider coverage compared to domestic GAAR and hence once may argue that there exists no conflict

Specific treaties permitting treaty override

- Various Indian tax treaties [for instance, with Singapore, Malta, Indonesia, Luxembourg, Malaysia, Colombia, Spain (though recent Protocol)] specifically provide for application of domestic anti-abuse provisions over the beneficial provisions of tax treaties
  - Does this imply that specific treaty override provisions are required under the tax treaties for application of domestic GAAR?

Recent protocol amending India-Spain DTAA

Protocol amending India-Spain DTAA

- The Indian government recently notified the protocol[1] signed on October 26, 2012 ("Protocol") to introduce a unique LOB clause to India-Spain DTAA

Treaty Override

- The Protocol, *inter alia*, introduces a treaty override provision to allow application of India's domestic GAAR over beneficial treaty provisions
  - Complements a similar override provision under India's domestic law
- Interaction of GAAR with tax treaties has been subject matter of debate - CBDT has clarified[2] that the GAAR continues to apply unless adequate anti-avoidance provisions are present in a tax treaty
- The amended India-Spain DTAA now negates the requirement of a standalone treaty LOB by incorporating treaty override provisions

[1]Notification S.O. 3079(E) [No. 58/2019/F. No. 503/02/1986-FTD-I], dated 27-8-2019

[2]Circular No. 7 of 2017 dated 27-1-2017

Protocol amending India-Spain DTAA

Beneficial ownership

- The Protocol clarifies that benefits under the tax treaty are only available to beneficial owners of income sourced from the other country
  - The phrase 'beneficial owner' is not defined in the treaty itself and has been subject matter of interpretation by different jurisdictions
  - The requirement of 'beneficial owner' was earlier applicable only for passive income – This condition has now been extended to all items of income

Retrospective application of the Protocol

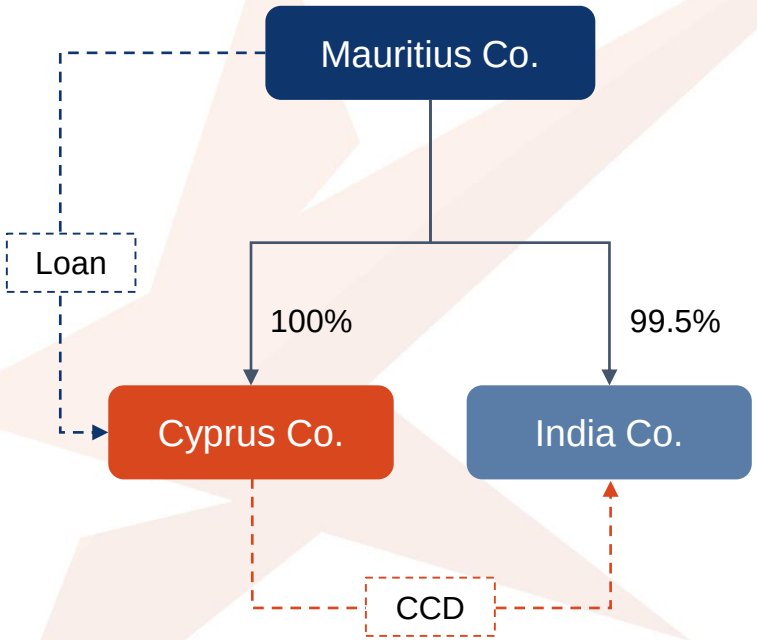
- While the Protocol was notified by the Indian government on August 27, 2019, the date of entry into force is December 29, 2014

- Would this imply that the Protocol can operate to deny treaty benefits in respect of a transaction from 1 April 2017 i.e. from the date when GAAR provisions were made applicable under the Indian domestic law?

Indian Jurisprudence on LOB

Indian Jurisprudence on LOB

Beneficial Ownership – Golden Bella Holdings Ltd. (Mumbai-Trib.)



WHT on interest income under DTAA

India-Cyprus DTAA – 10%
India-Mauritius DTAA – 40% (as per the earlier treaty provisions, WHT as per domestic law)

Facts of the case

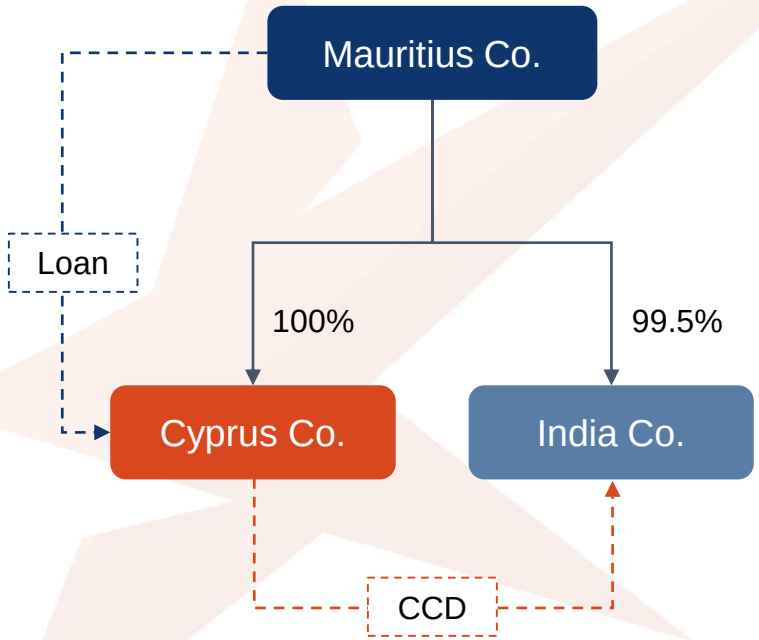
- Cyprus Co. (Taxpayer), is WOS of Mauritius Co.
- Cyprus Co. had subscribed to CCDs of Indian Co. (denominated in INR) at coupon rate of 15%
- Cyprus Co. offered to tax the interest earned on CCD @ 10% as per the India-Cyprus DTAA

Tax officer's contentions

- Tax officer denied treaty rate alleging that Cyprus Co. was not the beneficial owner of interest income
- Tax officer observed that investment in CCDs by Cyprus Co. is back-to-back loan and Cyprus Co. is a mere conduit for the passage of funds from Mauritius Co. to India Co.

Indian Jurisprudence on LOB

Beneficial Ownership – Golden Bella Holdings Ltd. (Mumbai-Trib.)



Tribunal's ruling

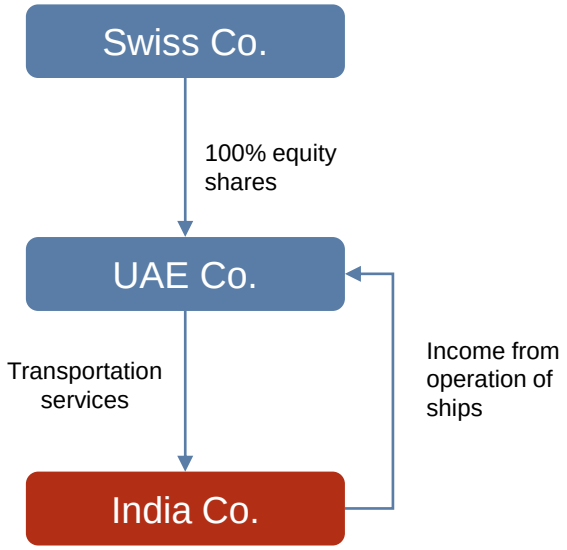
- Referring to OECD Commentary (2017) on Article 11, Tribunal observed that mere fact that the CCDs was funded using the funds received from shareholder does not make the arrangement a back-to-back transaction
- Tribunal observed that Cyprus Co. wholly assumed (i) **foreign exchange risk** on the CCDs (being denominated in INR) and (ii) **counter party risk on interest** on the CCDs
- Tribunal observed that tax authorities were unable to prove that –
  - Taxpayer did not have exclusive possession and control over the interest income
  - Taxpayer had to seek consent to invest in CCD
  - Taxpayer did not have complete discretion to utilize the interest income

Indian Jurisprudence on LOB

Derivative Benefit Rules – MUR Shipping DMC Co. (Rajkot-Trib.)

Brief Facts:

- UAE Co. is engaged in the business of shipping
- Entire shareholding of UAE Co. is held by Swiss Co.
- UAE Co. earned income from India Co. from operation of ships and claimed it to be not taxable in India as per Article 8 of the India-UAE DTAA
- Tax officer denied treaty benefits for following reasons:
  - Taxpayer was not subjected to tax in UAE and thus could not be treated as a resident of UAE
  - Tax officer also invoked Article 29 (Limitation of Benefit) of the India-UAE DTAA to deny the treaty benefit on the ground that main purpose of interposing UAE Co. by Swiss Co. was to avail treaty benefit under Article 8 of India-UAE DTAA
  - Swiss Co. would otherwise not be eligible for treaty benefits under Article 8 of India-Swiss DTAA since ships were owned by entity based in Marshall islands



WHT on Income from operation of ships under DTAA

India-Swiss DTAA – 0%
India-UAE DTAA – 0%

Right to taxation of 'Other Incomes' under India-Swiss DTAA is only with the Country of Residence under Article 22(1)

Indian Jurisprudence on LOB

Derivative Benefit Rules – MUR Shipping DMC Co. (Rajkot-Trib.)

Observations of Tribunal :

- Tribunal observed that protocol to India-UAE DTAA dated March 26, 2007 amended the definition of tax-resident to do away with the requirement of actual liability to pay tax
  - Thus, treaty benefits couldn't be declined on the ground that UAE tax-resident had actually not been taxed in UAE
- While focusing on the real intent of LOB clause in Article 29, Tribunal observed that only when creation of an entity is part of maneuvering, wholly or mainly, to obtain the benefits of the India-UAE DTAA which "would not be otherwise available", the benefits of India-UAE DTAA would be declined under Article 29
- It also observed that tax residency in Switzerland or UAE would not be pertinent since shipping income would in any case not be taxable in India either under Article 22(1) of India-Swiss DTAA or under Article 8 of India-UAE DTAA
- Thus, applying the analogy of Derivative Benefit Rule under SLOB along with PPT, Tribunal ruled in the favour of Taxpayer

Concluding Remarks

- The deposition of MLI by Indian government on 25 June 2019 with OECD is the final leg in India's sprint towards implementing the landmark MLI
  - BEPS changes for India are close to reality with the earliest application being **1 April 2020** at least in respect of Japan, Singapore, Netherlands, UK, Australia and France (being amongst 28 jurisdictions which have deposited the ratified MLI with OECD)

- With no grandfathering provisions for the existing structures in the MLI, cross-border holding transactions and structures will need to be evaluated in light of the stricter anti-avoidance measures

Q&A

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