Baroda Branch of ICAI

Treaty Abuse and Foreign tax credit

CA Kinjesh Thakkar

26 August 2016

Contents

Understanding Treaty Abuse through India Mauritius DTAA

Investments in India through Mauritius

Why?

Tax treaty between India and Mauritius signed in August 1982

Taxation of capital gains at the seller's residence country thereby exempting Mauritius residents from capital gains tax in India

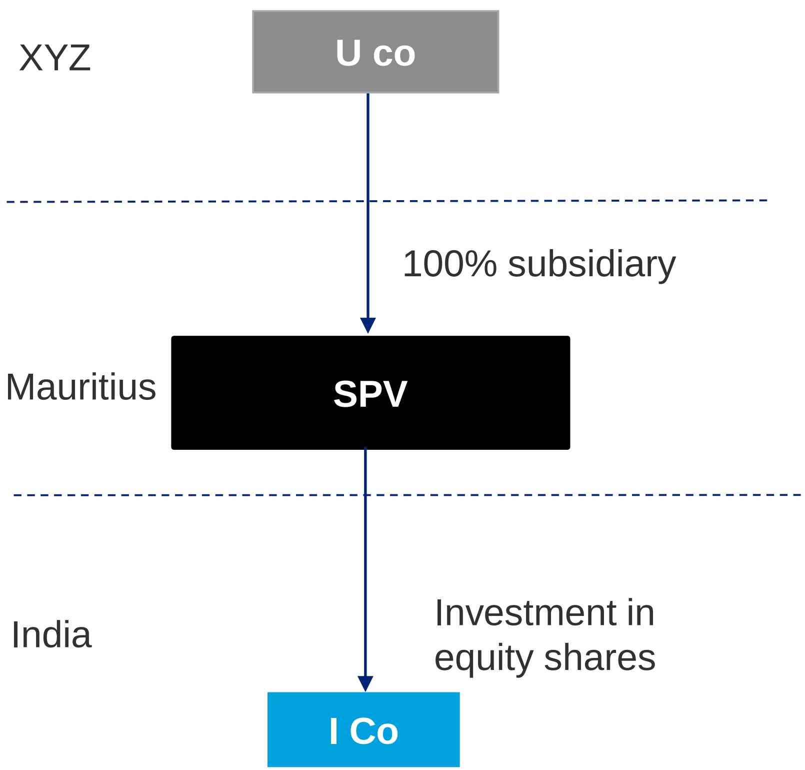
Under the Mauritius domestic tax law, capital gains are exempt from tax. Also, there is no withholding tax on repatriation of income from Mauritius.

Mauritius is also an attractive jurisdiction in terms of ease of setting up a company, regulatory compliances and administrative infrastructure available

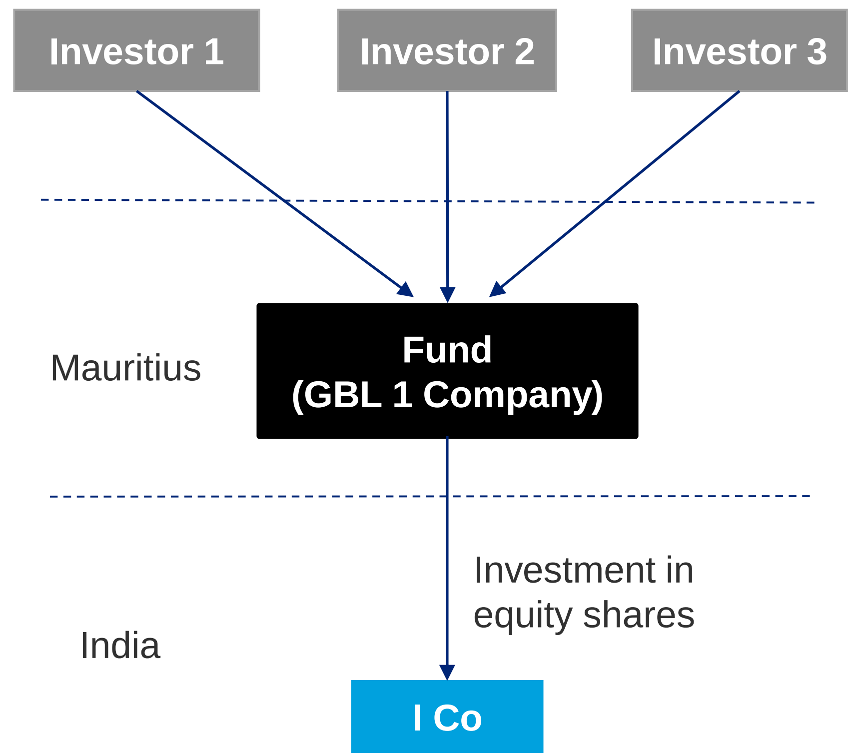
Treaty Abuse

India Mauritius DTAA - structures

SPV structure

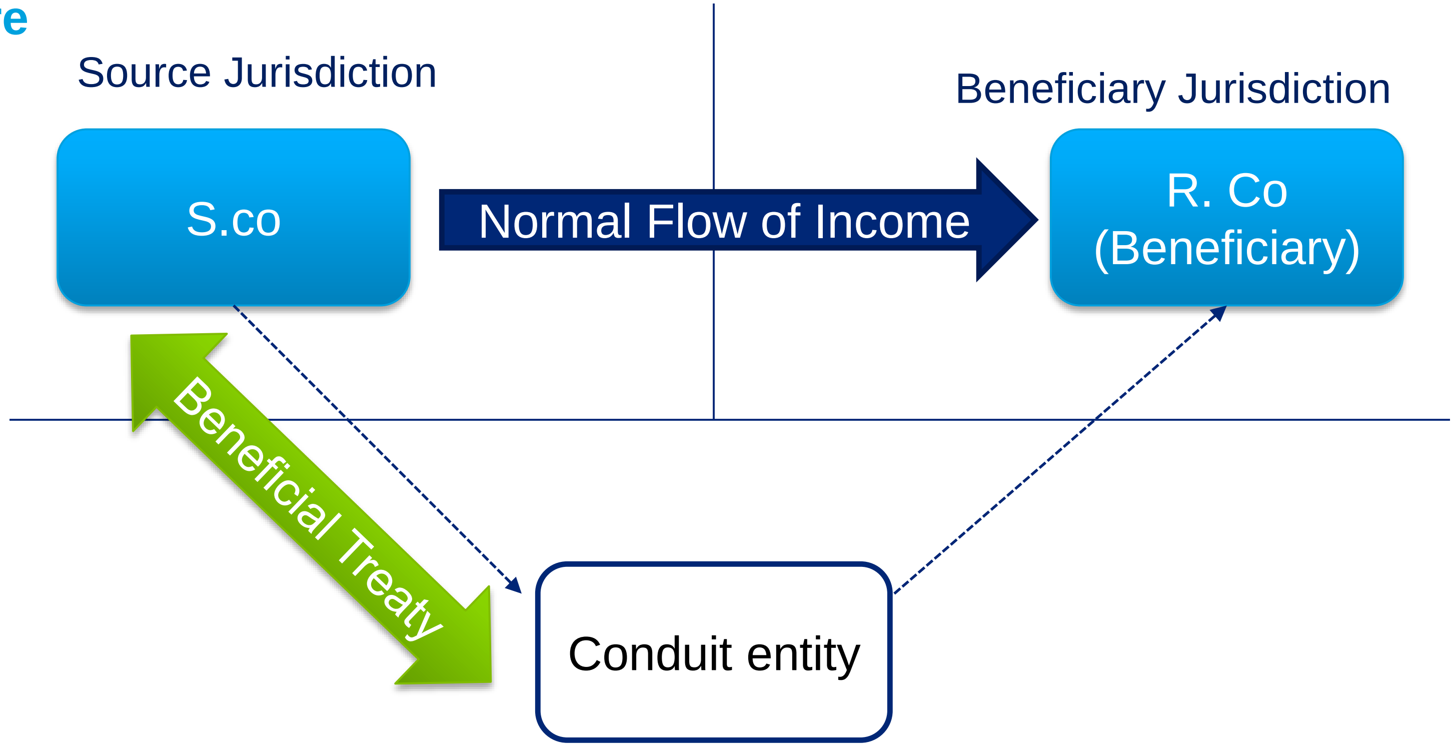


Pooling of investments in Mauritius



Treaty Abuse
Introduction

Structure



This is an example of Treaty Shopping wherein conduit entity is established in Jurisdiction with which source jurisdiction has favorable tax treaty. The overall result is reduction in tax liability for the same transaction.

Treaty Abuse

Treaty Shopping

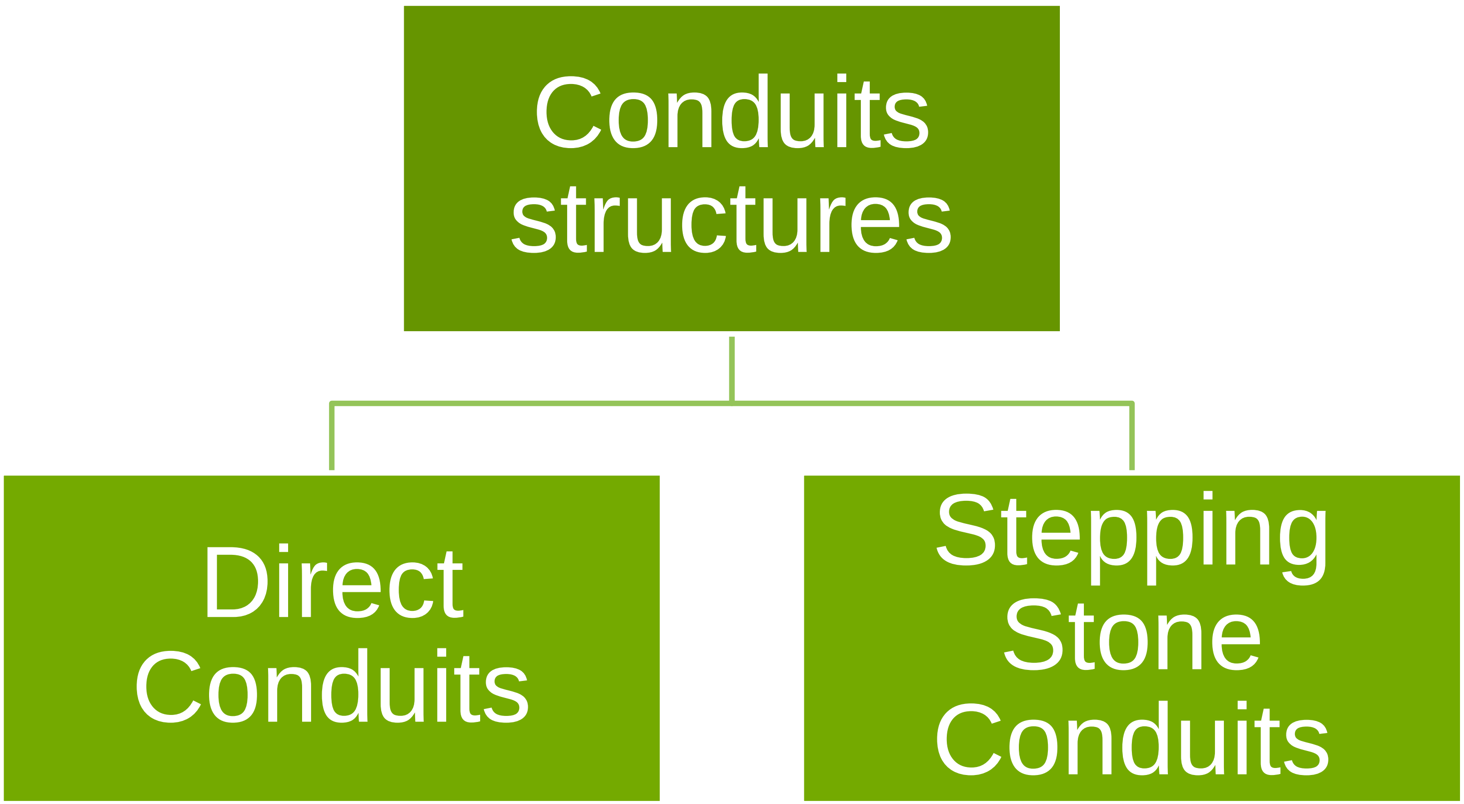
Concept

- The term 'treaty shopping' is thought to have originated in the US whereby a litigant tries to 'shop' between jurisdictions in which he expects a more favourable decision to be rendered.
- The practice of some investors of 'borrowing' a tax treaty by forming an entity in a country having a favourable tax treaty with the country of source
- Two elements for treaty Shopping

Treaty Abuse
Treaty Shopping

Structures

- Conduit Structures can be separated into following two categories:-

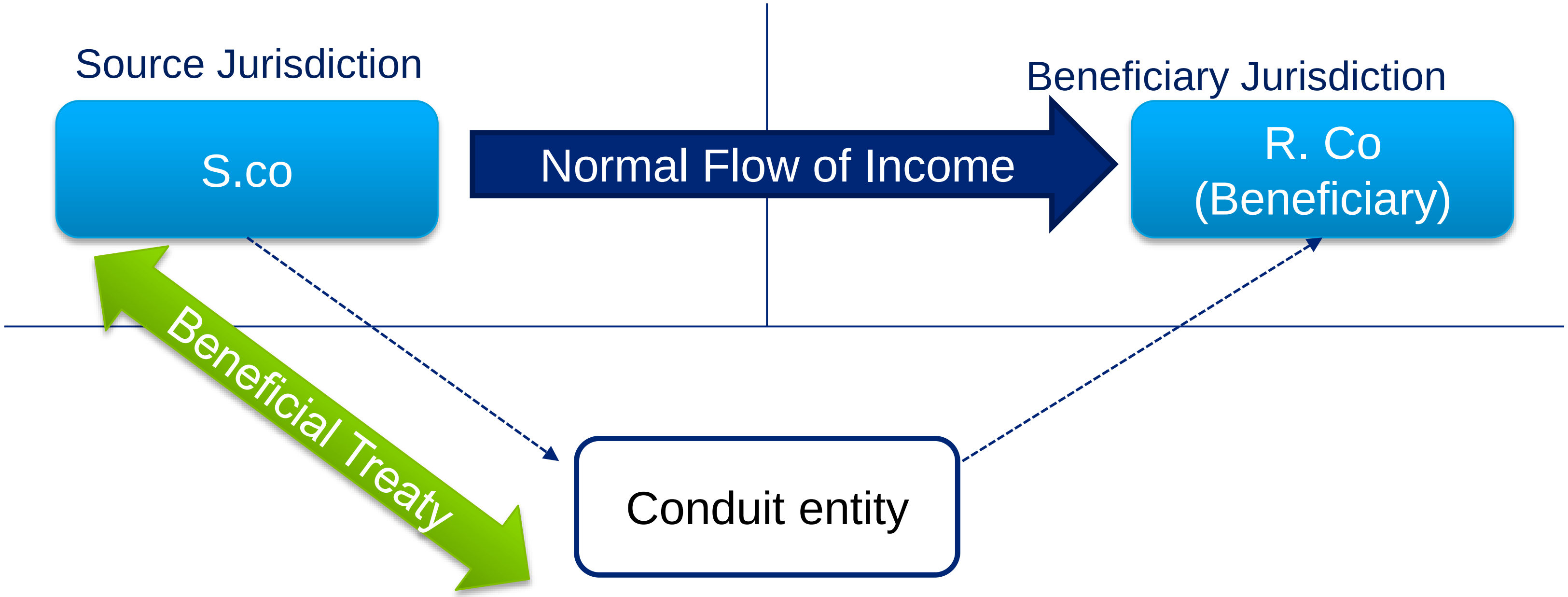


Treaty Abuse

Treaty Shopping

Direct Conduit Structures

- Conduit companies can be defined as the entities which are set-up by a person resident of a given State who is not entitled to the benefits of a tax treaty that are not directly available to him.
- This is created with a view of taking advantage of treaty and benefit arises to non-treaty resident country

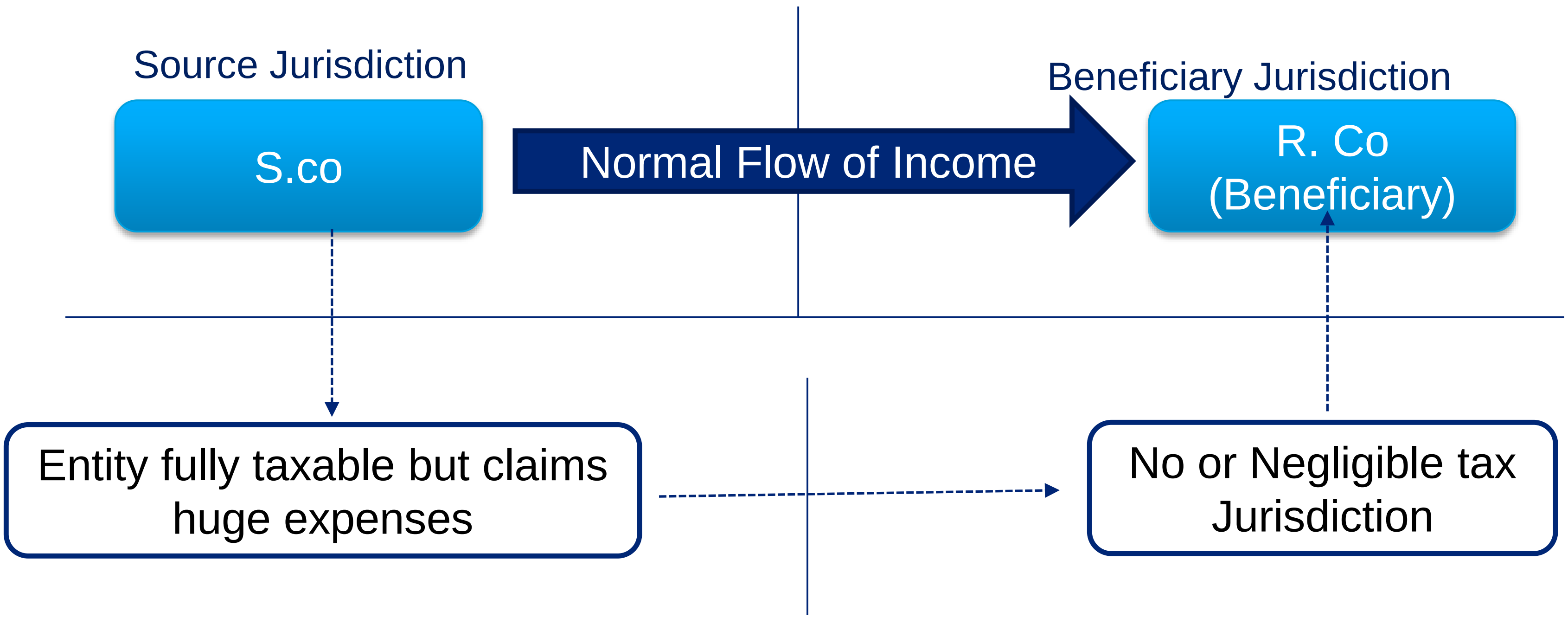


Treaty Abuse

Treaty Shopping

Stepping stone conduits

- Stepping-Stone conduits are variants of the direct conduit structures
- A additional layer is established and income is routed through 2 jurisdictions



Treaty Abuse

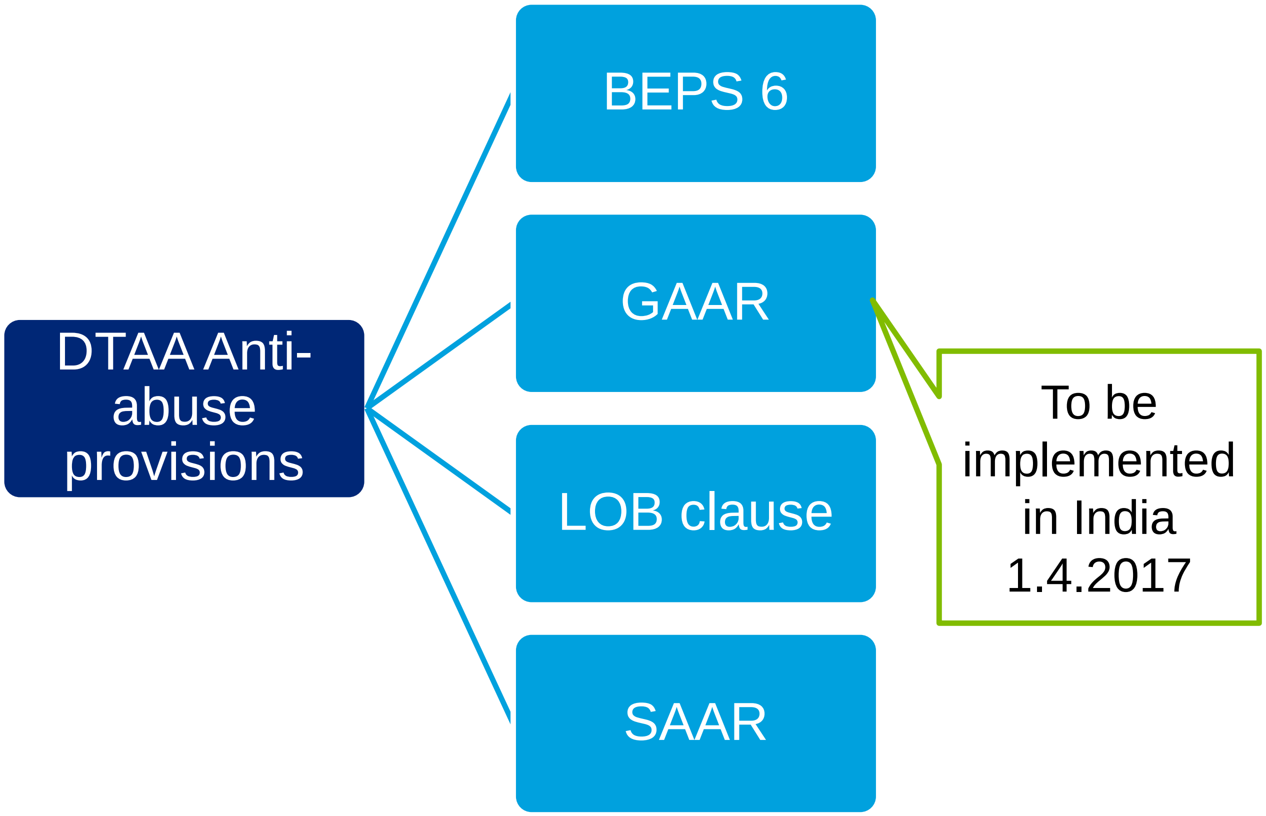
Treaty Shopping

Issues

- Undue Benefit
- Inappropriate share of taxes
- Erosion of tax base
- Abuse of treaties
- Specifically structured for reducing taxes
- Sometimes Results in No taxation at all rather than double taxation

Treaty Abuse
Elimination of undue treaty benefits

Analysis



Principal Purpose test (PPT) or Main purpose test

PPT

Prevention of treaty abuse

PPT rule

- General anti-abuse rules
- ***One of the principal purpose*** was to obtain treaty benefits and has resulted in benefit to the entity
- GAAR – on PPT rule

To establish business in state where treaty network is robust will fall in PPT rule?

PPT

Prevention of treaty abuse

PPT rule

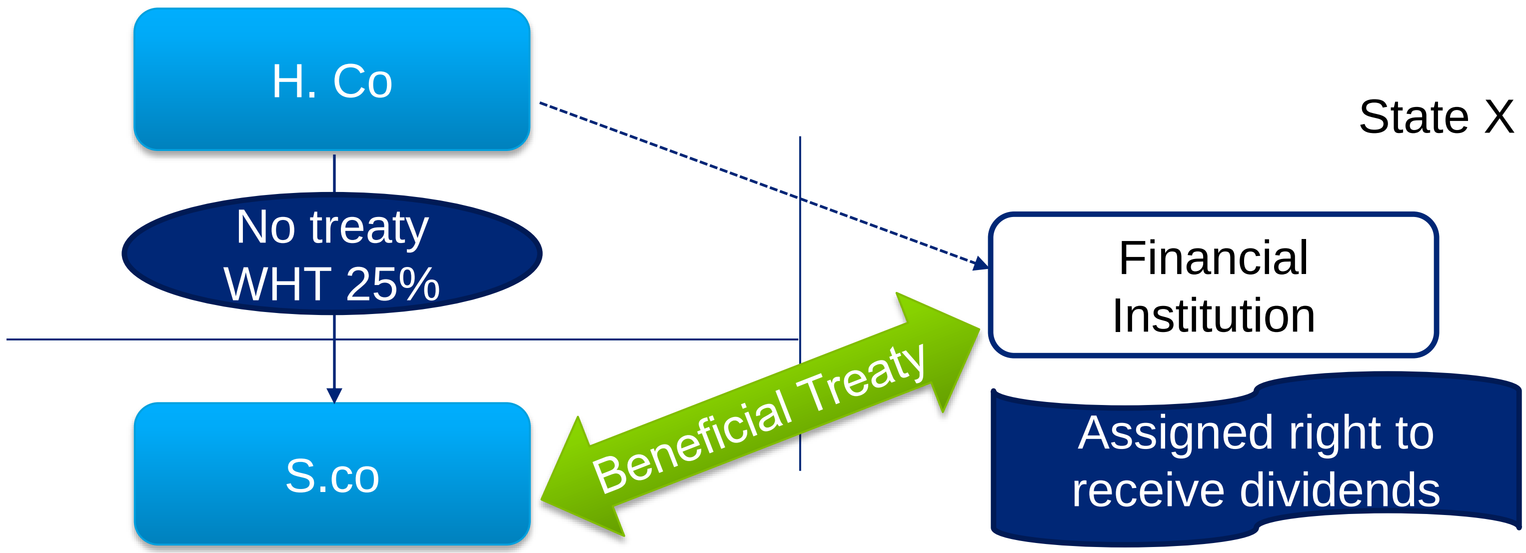
1. **Benefits of this Agreement shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, is to obtain benefits under this Agreement that would not otherwise be available*.***

2. The case of legal entities not having ***bona fide business activities*** shall be covered by the provisions of this Article.

3. Where by reason of this Article a resident of a Contracting State is denied the benefits of this Agreement in the other Contracting State, the competent authority of the other Contracting State shall notify the competent authority of the first-mentioned Contracting State.

PPT

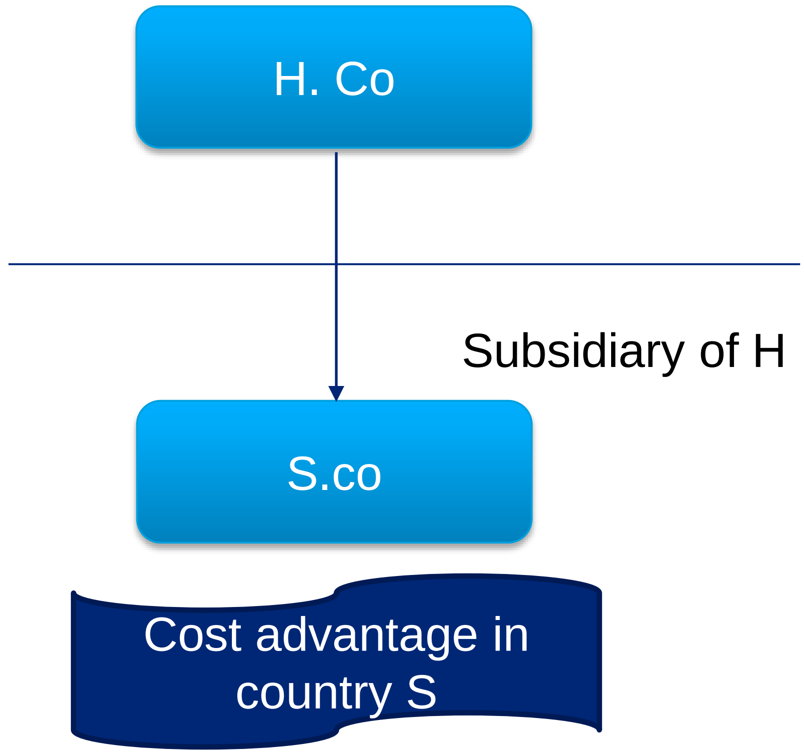
Example 1



Dividend from S to H	25% WHT
Dividend S to FI in state X	0% WHT

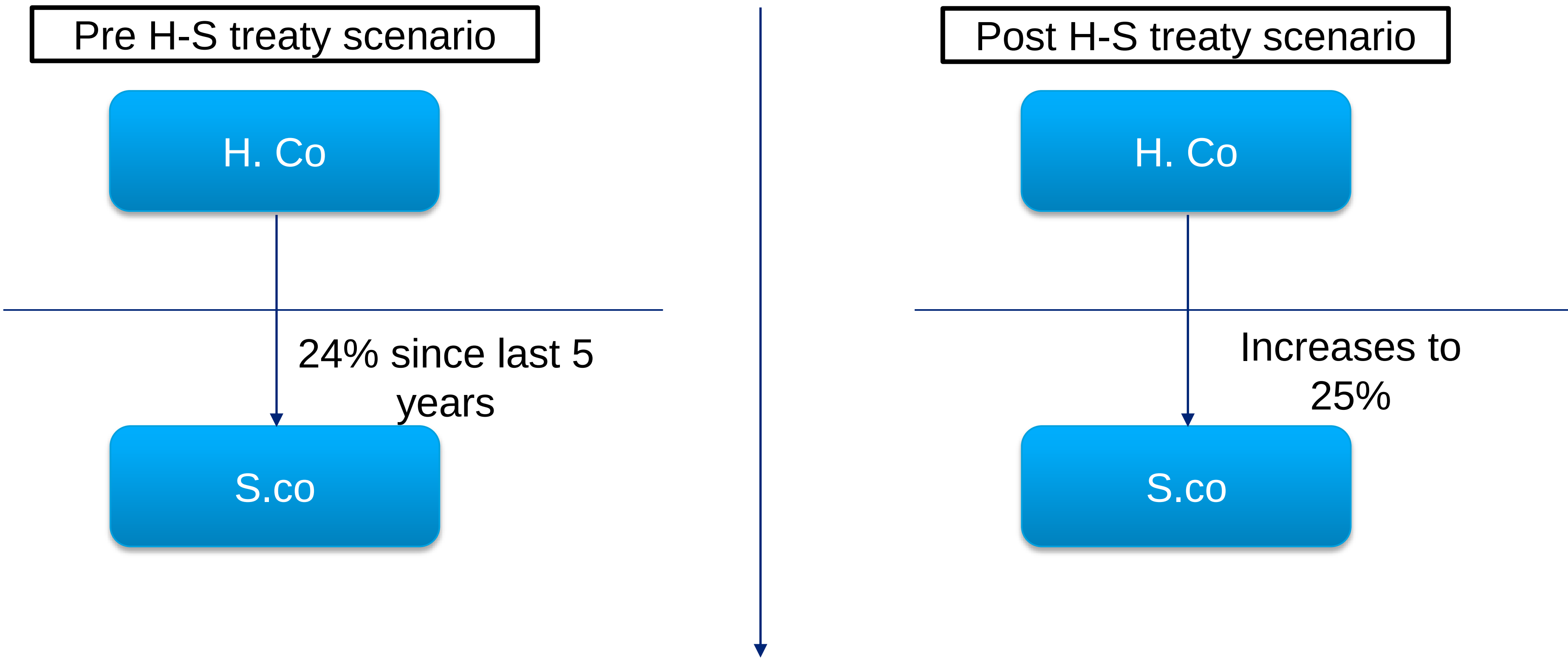
- PPT rule applies as one of the principal purpose was to obtain benefit

PPT
Example 2



- As principal purpose was cost advantage in country in S, PPT rule is not applicable

PPT
Example 3

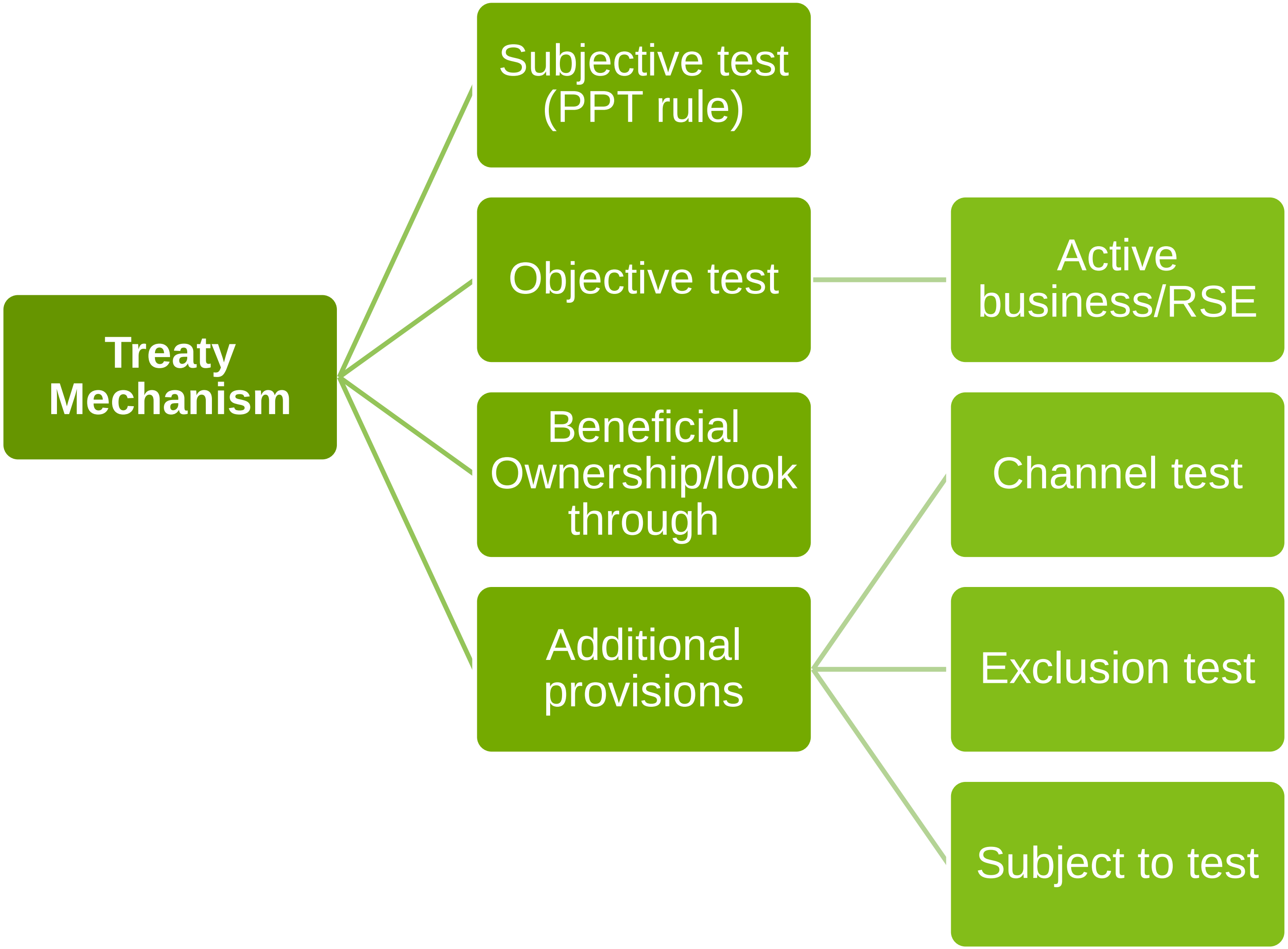


- H-S treaty provides for no dividend WHT if Holding is 25% or more.
- PPT rule applies?

Limitation of benefit

Limitation of Benefit

Elimination of undue treaty benefits



Prevention of treaty abuse

Anti abuse provisions

Objective test

How the Article generally reads (various criteria prescribed)

1. Benefits of the treaty will be available to a person (other than an individual), which is a resident of a Contracting State only if such a person is ***a qualified person*** as defined in paragraph 2.

2. A person of a Contracting State is a qualified person for a fiscal year only if such a person is either: (various criteria prescribed here)

3. The provisions of paragraphs 1 and 2 shall not apply and a resident of a Contracting State will be entitled to benefits of the treaty with respect to an item of income derived from the other State, if the person ***actively carries on business*** in the State of residence and the income from the other Contracting States is derived in connection with or is incidental to that business and that resident satisfies the other conditions of this Agreement for the obtaining of such benefits.

Prevention of treaty abuse

Anti abuse provisions

Objective test

How the Article generally reads (various criteria prescribed) – Cont.

4. A resident of a Contracting State shall nevertheless be granted the benefits of the Agreement if the Competent Authority of the other Contracting State determines that the establishment or acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Agreement.

5. Definition of ***recognized stock exchange*** is given under this sub-clause. (RSE listed company is qualified person for treaty benefits)

6. Notwithstanding anything contained in paragraphs 2 to 5 above, any person shall not be entitled to the benefits of this treaty, if its affairs are arranged in such a manner as if it is the main purpose or one of the main purposes to avoid taxes to which this treaty applies.

Prevention of treaty abuse

Anti abuse provisions

Beneficial Ownership/Look through

- Benefit only to be provided to **Beneficial owner**
- Benefit to be granted only if the treaty has nexus to shareholders of the conduit company (beneficial owner); the company's relationships with the shareholders or other interested parties and the decision-making process of the conduit company.
- This method would allow treaty benefits to flow to a company in the other contracting State only so far as its shares are held by residents of that State.
- The typical wording of the clause reads as follows:
- *'A company that is a resident of a Contracting State* ***shall not be entitled to relief*** *from taxation under this Convention with respect to any item of income, gains or profits* ***if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State****.*

Prevention of treaty abuse

Anti abuse provisions

Channel test

- The channel test, also called base erosion, **tries to catch intermediary entities whose tax base is eroded in favour of third-country residents through the payment of interest or royalties or by the discharge of obligations**.
- Such a provision might have the following wordings:
- *Where income arising to a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State: (a)have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or (b)exercise directly or indirectly, alone or together, the management or control of such company any provision of this Convention conferring an exemption from or a reduction of tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses and depreciation of any kind of business assets, including those on immaterial goods and processes).*

Prevention of treaty abuse

Anti abuse provisions

Exclusion test

- The exclusion **approach denies treaty benefits to companies that are tax-exempt or nearly tax-exempt.**
- This is the case when the country of residence gives qualifying companies tax privilege assimilating them in non-resident companies.
- An exclusion clause would read as follows:
- *'No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as define under section […] of […] the Act, or under any similar provision enacted by […] after signature of the convention.*

Prevention of treaty abuse

Anti abuse provisions

Subject to tax test

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

LOB – Summary of tax treaties

Type of LOB clause	Relevant tax treaty
In line with US LOB clause i.e. ➢ Ownership tests ➢ Active business tests ➢ Recognized stock exchange test; and ➢ Competent Authority test	– India-US tax treaty, India-Armenia tax treaty, India-Iceland tax treaty, India-Tajikistan tax treaty, India-Mexico tax treaty
Main purpose of arrangement is avoiding tax - anti abuse test	– India-Iceland tax treaty India-Tajikistan tax treaty, India-Mexico tax treaty, India-Mozambique tax treaty, India-Kuwait tax treaty, India-Luxembourg tax treaty, India-Myanmar tax treaty, India-United Arab Emirates tax treaty, India-Saudi Arabia tax treaty, India-Syrian Arab Republic tax treaty, India-UK Tax Treaty
Anti abuse as well as competent authority test	– Indian-Finland tax treaty
Domestic law overrides treaty in case of domestic anti abuse provisions	– India-Luxembourg tax treaty – India-Saudi Arabia tax treaty
Right of tax on foreign source income which is not taxable in other state	– India-Namibia tax treaty
Income remittance test	– India-Singapore tax treaty

BEPS Action 6
Prevention of treaty abuse

BEPS Action 6

Prevention of treaty abuse

Objective: Prevent granting of treaty benefits in inappropriate circumstances		
Model Treaty provisions and recommendation to design domestic anti avoidance rules	Clarify treaty should not be used for non-double taxation	Identify tax considerations while entering treaty

BEPS Action 6

Prevention of treaty abuse

Part A

- Abuse of treaty provision
- Abuse of domestic laws

Part B

- Change in treaty title and preamble

Part C

- Revised commentary and proposals where treaty benefits can be turned off

BEPS Action 6

Prevention of treaty abuse

Part A

PPT rule

- One of the principal purpose is to obtain treaty benefits
- GAAR also provides for same
- 16 examples in report

PPT and LOB

- One of the principal purpose is to obtain treaty benefits
- Series of objective test in case of LOB

LOB and anti conduit rules

- Series of test to escape out of LOB
- Anti conduit rules

BEPS Action 6

Prevention of treaty abuse

PART A

- **Either PPT alone – Subjective test**
- **PPT with LOB – combination of Objective and subjective test**
- **Or LOB with anti conduit rules – objective test in conjunction with rules to avoid benefit to passive entities established as intermediaries**

Anti conduit

- Anti conduit can be adopted in treaties or in domestic laws
- Unrelated parties where no income flows to group company is out of scope. Example – Loan granted to S.co by FI as H.co maintains large deposit at FI.

If different approaches are adopted, source state approach shall prevail

BEPS Action 6

Prevention of treaty abuse

PART B

Proposed title	***Current title***
Convention between state A and State B for the **elimination of double taxation** with respect to taxes on income **and prevention of tax evasion and avoidance**	Convention between state A and State B with respect to taxes on income and on capital

Preamble as per BEPS 6

- Eliminate double non taxation
- Not creating any opportunity for non taxation or tax avoidance (including treaty shopping or any other arrangement to provide indirect benefits to residents of 3rd state

Changes in India Mauritius DTAA

Amendments to India - Mauritius Tax Treaty

Key Provisions

Removal of capital gains tax exemption on shares

- Capital gains from alienation of shares of an Indian company acquired on or after April 2017 shall be subject to tax in India - **Source based taxation**
- Capital gains arising between April 2017 to March 2019 from alienation of shares of an Indian company acquired on or after April 1, 2017 to be taxed at 50% of Indian domestic tax rates, subject to compliance with Limitation of Benefits (LOB) clause - **Transitional provision allows time to investors to align strategies**
- Capital gains from alienation of other property (i.e. other than shares and assets covered in paragraphs 1 to 3 of Article 13) to be taxed only in Mauritius - **Tax exemption continues on other securities such as bonds, derivatives, mutual fund units and shares of non-Indian companies**

Amendments to India - Mauritius Tax Treaty

Key Provisions

LOB Clause to avail reduced tax rate from Apr’17 to Mar’19

- Benefit of 50% reduction in domestic tax rate not available if the investor’s affairs were arranged primarily to take tax advantage **– Main purpose test**
- A shell / conduit company not entitled to treaty benefits **– Shell / conduit company defined as a company with negligible or nil business operations with no real and continuous business activities**
- A company would be deemed to be a shell / conduit company if it’s expenditure on operations in Mauritius is less than Mauritian INR 1.5 Mio (approx $ 40K) in the immediately preceding 1 year before the date capital gains arise **– If a company meets this expenditure requirement, would it deemed to be not a shell / conduit company?**

Amendments to India - Mauritius Tax Treaty

Key Provisions

Interest income

- Tax rate on gross amount of interest not to exceed 7.5% **– No other treaty provides for such low tax rate on interest**
- Mauritius banks would continue to be fully exempt from tax on interest income earned from India on debt claims existing on or before March 31, 2017 **– Grandfathering of existing debt claims**

Foreign Tax Credit

FTC rules

Foreign Tax Credit

Types of Double Taxation

Juridical Double Taxation

- Same income of a person
- *Taxed in two different countries (jurisdictions)*
- Source Country and Resident Country Issue

Economic Double Taxation

- Same income
- *Taxed in the hands of two different person*
- *Example:* Corporate profits and Dividends

Foreign Tax Credit

Methods of Avoidance of Double Tax

- Methods of Avoidance of Tax
  - Exemption Method
    - Full exemption
    - Exemption with Progression
  - Credit Method
    - Full Credit
    - Ordinary Credit
  - Tax Sparing
  - Underlying tax Credit

Foreign Tax Credit rules

Rule 128 has been inserted to provide for rules on claim of foreign tax credit

It has been inserted via notification no. 54 dated 27 June 2016

Rule 128 is applicable to both for bilateral relief and unilateral relief.

Resolves various issues on foreign tax credit

Foreign Tax Credit rules

Claim of Foreign tax credit

- A resident tax payer shall be allowed foreign tax credit in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India.
- In case income is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.

Taxes covered

- Rule 128 provides for foreign tax credit against tax, surcharge and cess payable under the Act but not in respect of any sum payable by way of interest, fee or penalty.
- This affirms the position of judiciary which has held that credit to be available against surcharge, education cess in addition to Income tax or taxes similar to income tax

Foreign Tax Credit rules

Disputed tax demand

- Rule 128 does not allow credit of disputed tax demand i.e. where case of person is under audit proceedings by foreign tax authorities and an appeal or similar proceeding has been undertaken pending disposal.
- In such a scenario, tax credit can be claimed if the assessee furnished evidence of settlement of dispute with foreign tax authorities and discharge of tax payment liability along with undertaking of no refund within six months from end of month when the dispute has been finally settled.
- Further, disputed tax demand on settlement can be claimed in the year when such income is offered to tax.

Computation mechanism

- Rule 128 provides for lower of credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India or tax payable on same under the Act.

Foreign Tax Credit rules

Exchange rate

- The Foreign tax credit shall be converted to INR at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.

FTC against MAT

- Rule 128 provides for foreign tax credit to be settled against MAT payable by the assessee. Any credit over and above MAT shall be ignored
- Further, in case FTC is availed in respect of MAT for settlement of same, the taxpayer shall not be entitled to credit of MAT to the extent foreign tax credit has been used for settlement for payment of corporate taxes in future.

Foreign Tax Credit rules

Compliance

- To claim credit as per Rule 128, a series of compliances are required be carried out.

- This involves

1. **Filing of form no. 67** which provides for statement of Income and income tax paid in foreign jurisdiction

2. **A certificate signed by tax payer or from tax deductor or foreign tax authority** specifying nature of income and tax paid thereon. This shall be accompanied by challan of payment of tax or proof of deduction of tax.

- Both form no. 67 and certificate are required to be filed on or before due date of filing of return of income as prescribed under section 139.

Questions ???

Thank You

Kinjesh Thakkar

CA, CS, M.com
Contact No: +91 9662255337
E-mail ID: kinjeshthakkar@gmail.com

Disclaimer
The contents to this presentation are views expressed by author in its personal capacity and to the best of his knowledge. This has got no relation to professional life or organization to which it serves. It does not provide any opinion and is based on interpretation of author on publicly available information.