WIRC of ICAI

Refresher Course on International Tax

International tax planning: Focus on substance over form: Analysing the impact of Principal Purpose Test

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Views expressed are personal

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- General Anti Avoidance Rules (GAAR)
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Judicial evolution of Anti Avoidance Rules

Morality vs Legality of tax avoidance

Legal jurisprudence has dealt with issues relating to morality and legality of tax avoidance:

Lord Sumner in **IRC v. Fisher's Executors** [1926] AC 395 said:

"My Lords the highest authorities have always recognised that ***the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown so far as he can do so within the law,*** *and that he may legitimately claim the advantage of any expressed term or of any emotions that he can find in his favour in taxing Acts.* ***In so doing he neither comes under liability nor incurs blame."***

Lord Tomlin in case of **IRC v. Duke of Westminster** (1936) AC 1 observed that a taxpayer ***can arrange his affairs*** to minimize the tax payable regardless of his motive and taxpayers should be governed by the rule of law - preferably clear and certain laws. *"If he succeeds in arranging his affairs as such to secure the result, then, however, unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."*

Morality vs Legality of tax avoidance

In **Furniss v. Dawson [1984]** 1 All ER 530**, Ramsay** [1981 1 All ER 865] was re-iterated:

Lord Roskill - *"The error, if I may venture to use that word, into which the courts below have fallen is that they have looked back to 1936 and not forward from 1982. They do not appear to have appreciated the true significance of the passages in the speeches in Ramsay's case [1981] 1 All ER 865 at 872-873, 881, of Lord Wilberforce and Lord Fraser, and, even more important of the warnings in the Burmah Oil's case [1982] STC 30 at 32, 39 given by Lord Diplock and Lord Scarman in the passages to which my noble and learned friend Lord Brightman refers and which I will not repeat. It is perhaps worth recalling the warning given, albeit in another context by Lord Atkin, who himself dissented in the Duke of Westminster's case, in United Australia Ltd. v. Barclays Bank Ltd. [1940] 4 All ER 20 at 37, [1941] AC 1 at 29:* ***'When these ghosts of the past stand in the path of justice, clanking their mediaeval chains, the proper course for the judge is to pass through them undeterred., 1936, a bare half century ago, cannot be described as part of the Middle Ages but the ghost of the Duke of Westminster and of his transaction, be it noted a single and not a composite transaction, with his gardener and with other members of his staff has hounted the administration of this branch of the law for too long. I confess that I had hoped that that ghost might have found quietude with the decisions in Ramsay and in Burmah. Unhappily it has not****. Perhaps the decision of this House in these appeals will now suffice as exorcism." [Emphasis supplied]*

Morality vs Legality of tax avoidance

Mc Dowell & Co Ltd vs CTO (1985) 154 ITR 148 (SC)

This case was a departure from the Westminster principle. It was held that any tax planning intended to and that results in tax avoidance must be struck down. It was observed that *'Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.'*

"Thus, the ghost of Westminster (in the words of Lord Roskill) has been exorcised in England. Should it be allowed to rear its head in India?

We think that time has come for us to depart from the Westminster principle as emphatically as the British Courts have done and to dissociate ourselves from the observations of Shah, J. and similar observations made elsewhere. The evil consequences of tax avoidance are manifold….. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

Morality vs Legality of tax avoidance

- **UOI vs Azadi Bachao Andolan (263 ITR 706) (SC)**
  - An act otherwise valid in law cannot be treated as non est merely on basis of underlying motive
  - In absence of limitation clause, resident of a third nation cannot be denied benefits of a treaty
  - Many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development
  - Whether treaty shopping should continue and if so, for how long, is at the discretion of the Executive. The Court not to judge the legality of treaty shopping
  - McDowell cannot be read as laying down that every attempt of tax planning is illegitimate and must be ignored

- **Vodafone International Holdings B.V. vs UOI (Supreme Court Ruling)**
  - No conflict between Westminster/ McDowell and Azadi Bachao
  - Taxpayer entitled to arrange its affairs so as to reduce tax incidence
  - Revenue cannot apply ‘look-through’ approach without a statute to support

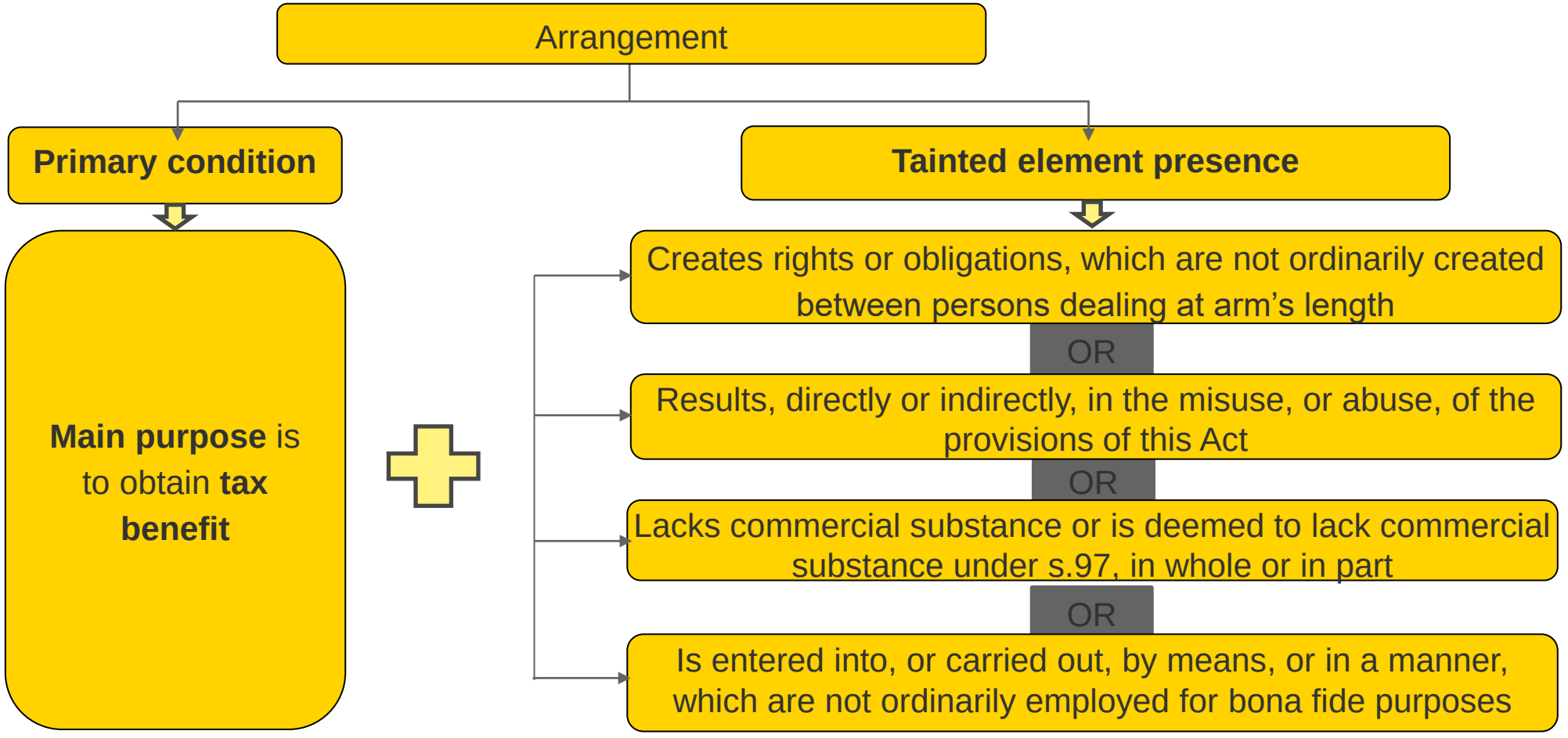
General Anti Avoidance Rules (GAAR)

GAAR - Genesis

- **Tax avoidance** is the result of actions taken by the taxpayer, none of which or no combination of which are illegal or forbidden by law
- **Tax evasion** is generally the result of illegality, suppression, misrepresentation and fraud. It involves outright concealment of transactions, non disclosure of income or similar acts
- **Tax planning** is an exercise undertaken to minimize tax liability through the best use of all available allowances, deductions, exemptions, exclusions, etc.
- Indian judiciary has accorded favourable treatment to tax planning as opposed to cases of tax evasion or tax avoidance
- GAAR was introduced to deal with cases of aggressive tax planning/ tax avoidance cases and codify the doctrine of ‘substance over form’

Overview of GAAR

- An **arrangement** is an impermissible avoidance arrangement (IAA) if:



Overview of GAAR

- ***Tax benefit*** widely defined
  - Reduction/avoidance/deferral of tax, increase in refund of tax (even if it is as a result of a tax treaty), reduction in total income including increase in loss

- ***Commercial substance*** test fails if,
  - Substance of arrangement is inconsistent or differs significantly from individual steps
  - Arrangement includes round trip financing, accommodating party, offsetting elements, etc
  - Locating asset / transaction / place of residence for tax benefit without substantial commercial purpose

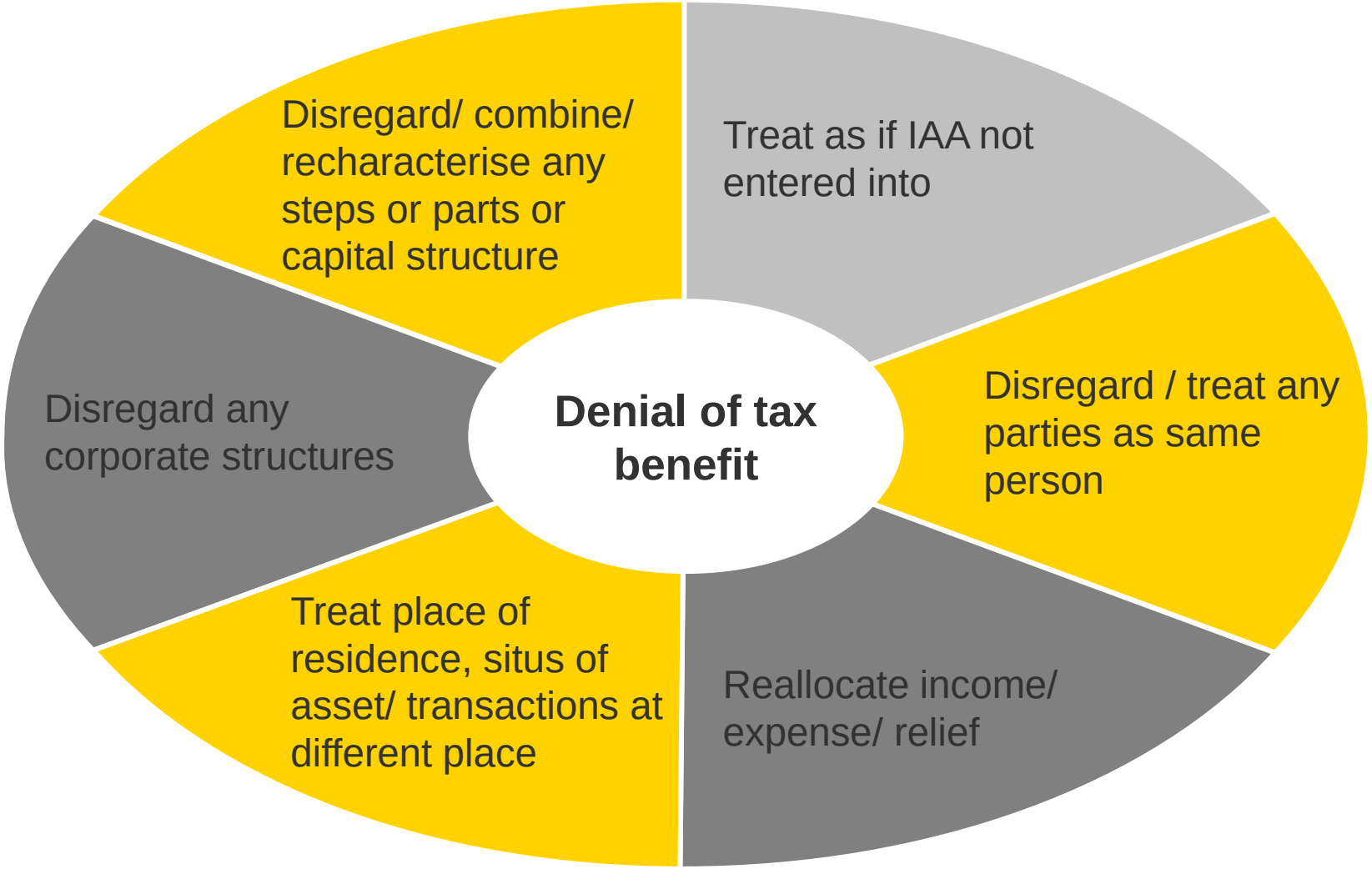
- GAAR may be applied to any step in or part of the arrangement

- GAAR can be used in addition to or in conjunction with other anti avoidance provisions

- Onus of proving existence of IAA is on the tax authorities

Overview of GAAR *<Should we delete this slide as next slide elaborates this>*

Consequences of IAA are inclusive; but not limited to those below



Consequences of GAAR

Section	Consequences	Example
98(1)(a)	Disregarding any step or part or whole	Gift of shares to entity in TFJ just prior to sale
98(1)(a)	Combining or re-characterising any step or part or whole	Formation of partnership firm, contribution, revaluation and retirement: Combined effect is sale
98(1)(b)	Treat as if IAA not entered into	Ignoring setting up of SPV in TFJ
98(1)(c)	Disregard / treat any accommodating party and another as one and same	Routing loan via Bank in TFJ: Bank regarded as an accommodating party
98(1)(d)	Deeming connected persons to be one and the same	Split investment between two entities to claim portfolio investment exemption under treaty
98(1)(e)	Reallocate income/ expense/ relief	Back ended revenue under contract spread over life of contract
98(1)(f)	Treat place of residence, situs of asset or transaction at different place	Entity in TFJ being regarded as resident of NTFJ where the control is
98(1)(g)	Disregard/ look through any corporate structure	Lifting the corporate veil

Consequences are inclusive; and are determined in such manner as is "deemed appropriate"

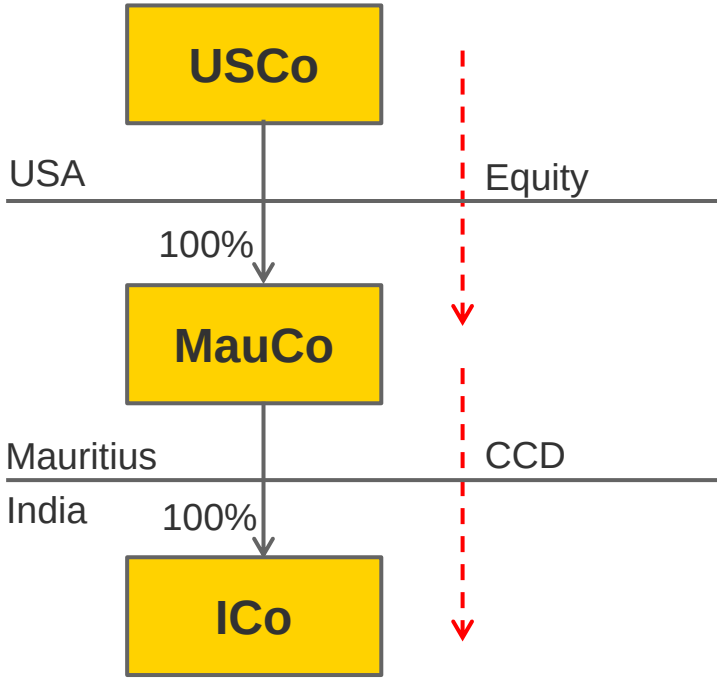
Threshold for applicability of GAAR

- ***Rule 10U of the Income-tax Rules, 1962 –*** Provisions of GAAR shall not be invoked in the following circumstances

  - Sub-rule (a) - *an arrangement where the **tax benefit** in the relevant assessment year arising, in aggregate, to all the parties to the arrangement **does not exceed a sum of rupees three crore***

  - *Sub-rule (d) - any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before 1 April 2017 by such person*

Evaluating Rs 3 Cr. limit for Rule 10U(1)(a)



I-M Interest WHT	7.5%
I-US Interest WHT	15%
Domestic law WHT	40% + SC

- USCo has 100% subsidiary MauCo; that has 100% subsidiary ICo
- MauCo issues equity to USCo; ICo issues CCDs to MauCo
- USCo and MauCo hold valid TRC and are entitled to treaty benefit
- ICo pays interest on CCDs to MauCo at ALP (assume Rs. 30 Cr.)
- CCD is not re-characterized as equity
- Interest is deductible in hands of ICo and is subject to WHT in terms of revised India-Mauritius Treaty.
- De-minimis threshold for invoking GAAR is Rs. 3 Cr. - Is it crossed?
  - If treaty benefit of I-US is available?
  - If treaty benefit is denied fully?

CBDT’s clarification – Circular No. 7 of 2017

Q1. Will GAAR be invoked if SAAR applies

A. Specific anti-avoidance provisions may not address all situations of abuse, and there is need for general anti-abuse provisions. The GAAR and SAAR can co-exist as applicable in the facts of the case

Q3. Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?

A**.** GAAR will not interplay with such right of the taxpayer

Q7. Will GAAR apply if arrangement has been held as permissible by the Authority for Advance Ruling (AAR)

A. No. The AAR ruling is binding on the PCIT/ CIT and the income tax authorities sub-ordinate to him, in respect of the applicant.

CBDT’s clarification – Circular No. 7 of 2017

Q8. Will GAAR apply if the arrangement is sanctioned by an authority such as a Court, National Company Law Tribunal, or is in accordance with judicial precedents, etc.?

A. Where the Court has explicitly and adequately considered the tax implications while sanctioning an arrangement, GAAR will not apply to such arrangement.

Q. 14. How is de-minimis threshold of INR 3 crores to be considered?

A. Such benefit is assessment year specific and with respect to an arrangement or part of the arrangement. Therefore, limit of INR 3 crores cannot be read in respect of single taxpayer only. Further, ‘tax benefit’ enjoyed in Indian jurisdiction due to the arrangement or part of the arrangement to be seen and examined

Overview of Multilateral Instrument (MLI)

MLI - An Introduction

- MLI is an instrument which implements tax treaty related measures of BEPS
- The treaties which will stand modified to incorporate treaty related BEPS measures via the MLI are called as “Covered Tax Agreements (CTA)”
- An existing tax treaty shall be considered as a CTA only if the following conditions are satisfied:
  - Both the countries to the bilateral tax treaty have signed the MLI
  - Both the countries have ratified the MLI under their domestic procedures
  - Both the countries have deposited the ratified copy of MLI with OECD
- Along with ratified copy of MLI (with notifications and reservations), both the countries to a bilateral tax treaty have listed each other in their respective list of treaties which are to be modified by MLI and have submitted the list to OECD
- Once the MLI is effective for the contracting parties, the existing treaty will need to be read along with the provisions as opted under the MLI by the contracting countries

MLI - An Introduction - India's status on MLI

- The Indian Government has deposited the ratified copy of MLI on 25 June 2019 with OECD along with its list of tax treaties that India wants to modify through the MLI and its final positions and reservations on various articles of the MLI

- This is the final leg in India's sprint towards effectuating the landmark MLI. India has notified 93 tax treaties i.e. all its comprehensive tax treaties, excluding China

- The MLI shall enter into force for India on 1 October 2019

- Further, as of 28 June 2019, in addition to India, 28 other countries have also deposited the ratified MLI with OECD which includes some of India's major treaty partners such as Australia, France, Netherlands, Japan, Singapore and UK. Such treaties shall now qualify as CTA and from India perspective, the MLI shall be effective with respect to these CTAs from 1 April 2020 (A.Y. 2021-22)

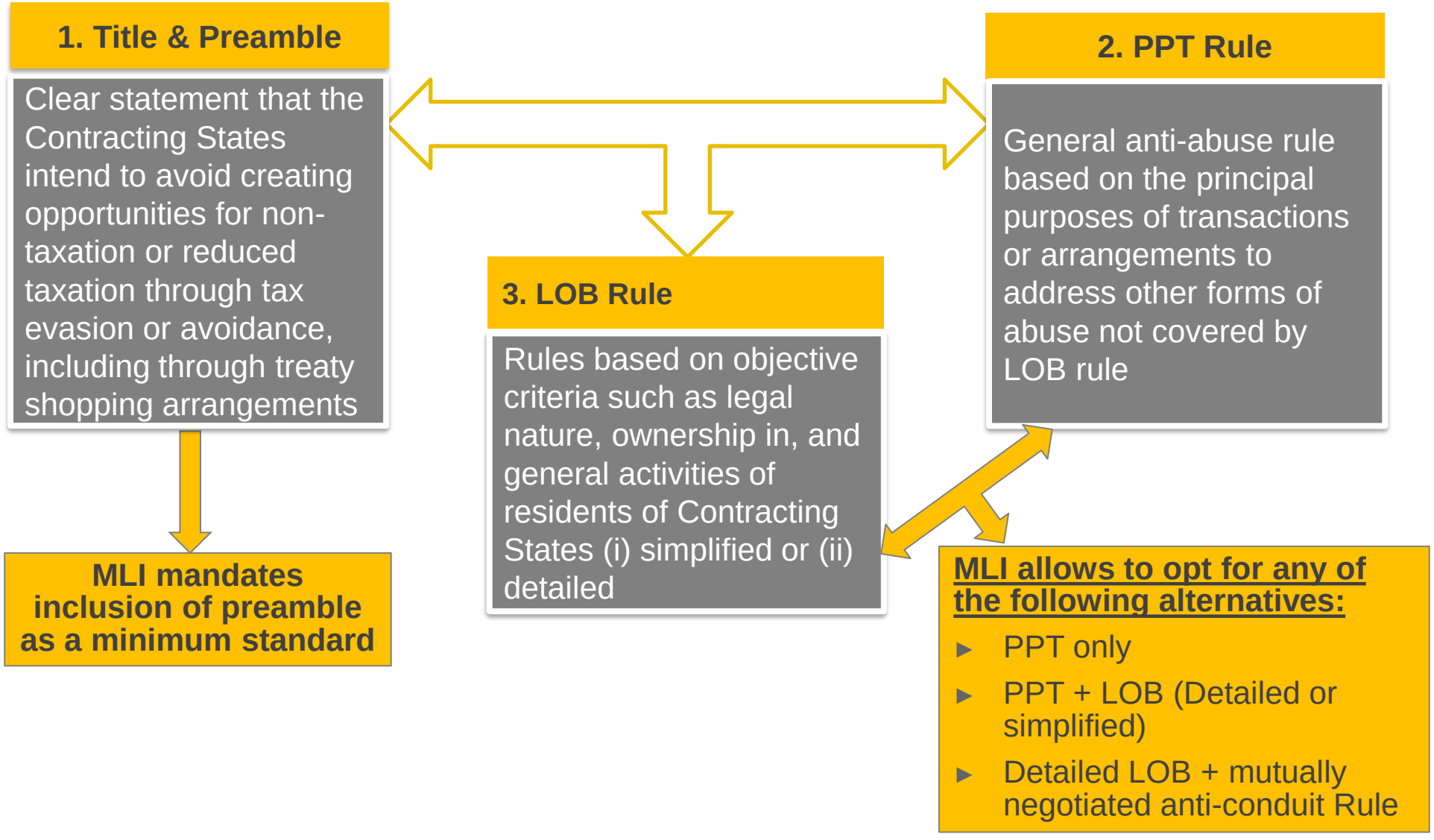
Principal Purpose Test (PPT)

A prelude …

The lawyer cabled his client overseas: 'Your mother-in-law passed away in her sleep. Shall we order burial, embalming or cremation?'

Back came the reply, 'Take no chances - order all three.'

Three-pronged approach of BEPS Action 6 for prevention of treaty abuse



Object and purpose of CTA/MLI

- Preamble to MLI:
  - *Recognising that governments lose substantial corporate tax revenue because of aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation;*
  - *Noting the need to ensure that existing agreements…are interpreted to eliminate double taxation …without creating opportunities for non-taxation or reduced taxation …including through treaty-shopping arrangements…;*
- India's statements in Explanatory Memorandum to Finance Bill 2020:
  - *The MLI will modify India's DTAAs to curb revenue loss through treaty abuse…by ensuring that profits are taxed where substantive economic activities generating the profits are carried out…*

Article 7 of MLI – Prevention of Treaty Abuse

"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,* ('reasonable purpose test')

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.****"*
('object and purpose test')

Tax benefit under treaty

- Non-obstante provision with mandate of denial of treaty benefit
- Denial of treaty benefit is the only consequence
- Extends to direct as also indirect benefit under CTA
- “Benefit” covers all limitations on taxation imposed on the COS as also treaty benefit obtained in COR
- No impact on tax concessions admissible in domestic law (e.g. lower withholding rate admissible u/s 194LC/LD)

Reasonable purpose test

- Granular approach: Evaluate w. r. t. each arrangement, each stream of income; not *qua* entity as a whole
- Applies to an arrangement if its "one of the principal purpose" is to claim benefit of a tax treaty
  - Obtaining treaty benefit need not be sole or dominant purpose
- Purpose of "arrangement" – an inanimate exercise
  - Question of fact: Requires objective analysis of all relevant facts and circumstances
- "Reasonable to conclude":
  - Having sound judgment, fair, sensible, logical (not unreasonable)
  - Alternative views need to be examined objectively
  - All evidences must be weighed
  - Looking merely at the 'effect' not sufficient – tax benefit purpose not to be assumed lightly
  - Self assertion by taxpayer not sufficient; also no conclusive evidence requirement

Is arrangement capable of being explained but for treaty benefit? **OR,**
Is treaty benefit in itself justifying the transaction?

Object and purpose test

- Even if treaty benefit is one of the principal purpose, PPT carve out protects treaty benefit if ***'it accords with object and purpose of relevant provisions of CTA'***
- Onus to "establish" applicability of carve out lies on taxpayer
- Reasonable purpose test = Question of fact;

  Object and purpose carve out = Question of law
- Evaluate object and purpose of relevant treaty provisions (implicitly, in overall treaty context including modified preamble)
- Object and purpose of distributive articles based on quantitative criteria v/s other distributive rules v/s general anti-avoidance provision of the treaty

Messages/ examples from OECD 2017 Commentary

- *The provision is intended to ensure that tax conventions apply …to provide benefits in respect of* ***bona fide exchanges of goods and services, and movements of capital and persons*** *as opposed to arrangements whose principal objective is to secure a more favourable tax treatment. (para 174)*
- *It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but* ***it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances****, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention… Where, however,* ***an arrangement can only be reasonably explained by a benefit that arises under a treaty,*** *it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit. (para 178)*
- *…where* ***an arrangement is inextricably linked to a core commercial activity…****it is unlikely that its principal purpose will be considered to be to obtain that benefit. (para 181)*
- *…it is clear that the* ***principal purposes for making that investment and building the plant are related to the expansion of RCO's business and the lower manufacturing costs*** *of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits. In addition, given that a* ***general objective of tax conventions is to encourage cross-border investment,*** *obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention (Example C)*

Messages/ examples from OECD 2017 Commentary

- *RCO is a company resident of State R and, for the last 5 years, has held 24 per cent of the shares of company SCO…RCO decides to increase to 25 per cent its ownership of the shares of SCO. Although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of Article 10(2) a), paragraph 9 would not apply because it may be established that* ***granting that benefit in these circumstances would be in accordance with the object and purpose*** *of Article 10(2)a). (Example E)*
- ***After a review of possible locations,*** *TCO decides to establish the regional company, RCO, in State R. This* ***decision is mainly driven by the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation treaty network of State R,*** *including its tax treaties with the five States in which TCO owns subsidiaries, which all provide low withholding tax rates… Assuming that the intra-group services to be provided by FCO…constitute a* ***real business*** *through which FCO exercises* ***substantive economic functions, using real assets and assuming real risks,*** *and that business is carried on by FCO through its own personnel located in State F, it would not be reasonable to deny the benefits… (Example G)*
- *Issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners make it difficult for TCO to manage its foreign activities from State T. TCO therefore establishes RCO, a subsidiary resident of State R (a country where there are* ***developed international trade and financial markets*** *as well as an* ***abundance of highly-qualified human resources****), as a base for developing its foreign business activities… (Example H)*

Treaty objects*

- Eliminate double taxation: promote (bona fide) exchange of goods and services, and movement of capital and persons
- Foster economic relations, trade and investment
- Provide certainty to taxpayers
- Prevent tax avoidance and evasion
- Promote exchange of information
- Strike a bargain between two treaty countries as to division of tax revenues
- Eliminate certain forms of discrimination
- Language of Preamble (as modified by MLI) to aid determination of object and purpose

** Commentary by Prof. Philip Baker titled "Double Taxation Conventions" at Para B.09 on Page B-7; OECD Commentary 2017 on Article 1; para 174 of OECD Commentary 2017 on Article 29(9); Linklaters LLP [2010] 40 SOT 51 (Mum.)*

Commercial reasons for formation of separate entities

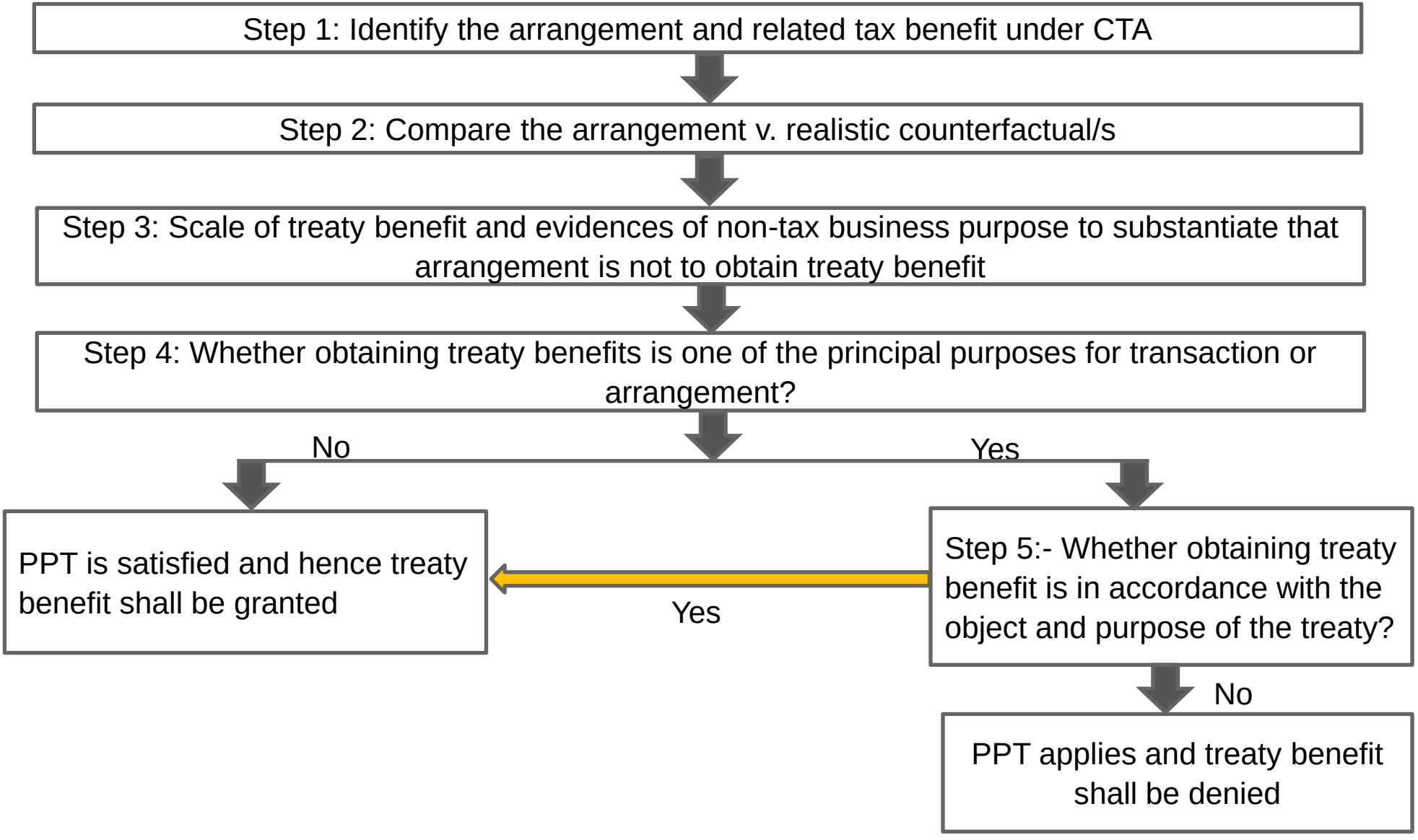
Illustrative commercial factors for SPV formation from Vodafone [2012] 341 ITR 1 (SC)

- Better corporate governance;
- Hedging business risk (for instance, high-risk assets may be parked in a separate company so as to avoid legal and technical risks to the MNE group) and political risk;
- Protection from legal liabilities;
- Mobility of investment;
- Enable creditors to lend against specified investment or division; creditors may not have to monitor the performance of the whole group; to limit the information which creditor should have;
- Facilitate an exit route;
- Promoting specialization

OECD Guidance on selection of location: “location test”

- Availability of skilled, multilingual work force and directors with knowledge of regional business practices and applicable regulations
- Membership of a regional grouping
- Extensive tax treaty network
- Reliable regulatory and legal framework; business friendly environment
- Developed international trade and financial markets
- Political stability
- Sophisticated banking industry
- Lender and investor familiarity
- Lower operating cost
- Difficulties/ limitations of home jurisdiction are ironed out in SPV jurisdiction

Step process for evaluation of PPT



Concluding thoughts on PPT

To quote the words of eminent jurist Mr. Philip Baker[1]

> *"There is every reason to fear that, once the MLI is in force and a large number of countries (including ones with tax authorities that do not have a reputation for predictable interpretation of tax treaties) begin to apply the PPT, this will undermine the whole system of tax treaty benefits. Put simply,* ***no taxpayer*** *who has given any consideration to the impact of a tax treaty on its transactions or arrangements* ***will be able to rely with any certainty on obtaining the benefits of the tax treaty.***

[1] *P. Baker, The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, British Tax Review 3, 2017, p. 283*

Interplay between PPT and GAAR

PPT and GAAR interplay - “One of the principal purposes” v. “main purpose” test

Threshold is not same, PPT has lower threshold

- In India, “main purpose” threshold introduced post significant debate and to allay fear of wider canvass of “one of the main purpose” test
- UK HMRC GAAR guidance states that “one of the main purpose” test is wide to cover transactions implemented for commercial reasons and also ‘substantial’ tax advantage
- UN Commentary 2011 on Article 1 – “main purpose test” may be interpreted restrictively in favour of taxpayers and render provision ineffective
- UN handbook suggests that “one of the main purpose” test is relatively easy to satisfy than “main purpose test”

Threshold is practically same

- Dictionary meanings of ‘main’ and ‘principal’ suggest that they both refer to something ‘chief’, ‘primary’ or ‘most important’
- OECD PPT examples give flavour that PPT applies only when treaty benefit is “the main” reason for the transaction
- Both require objective analysis of facts and circumstances; and both factor the object and purpose of an arrangement
- Para 181 of OECD Commentary 2017 states that, to trigger PPT, obtaining treaty benefit should be “a principal consideration” behind entering into any arrangement or transaction

PPT and GAAR interplay

Particulars	Domestic GAAR	Article 7 of MLI (PPT)
Applicability	• Main purpose is tax benefit (Primary Test); and • One of the tainted element tests is present (Secondary Test)	• One of the principal purposes is to obtain benefit of a tax treaty; and • Such purpose is not in accordance with object and purpose of treaty/ article
Consequences	Re-characterization of transaction, re-allocation of income (includes denial of treaty benefit)	Denial of treaty benefit
Onus	Primary onus on tax authority	Primary onus on tax authority and rebuttal assumption for carve out
Administrative safeguards	Approving Panel	To be determined by respective states. OECD and UN Model Commentaries suggests this
Grandfathering	Yes	No
De-minimis threshold	Yes	No

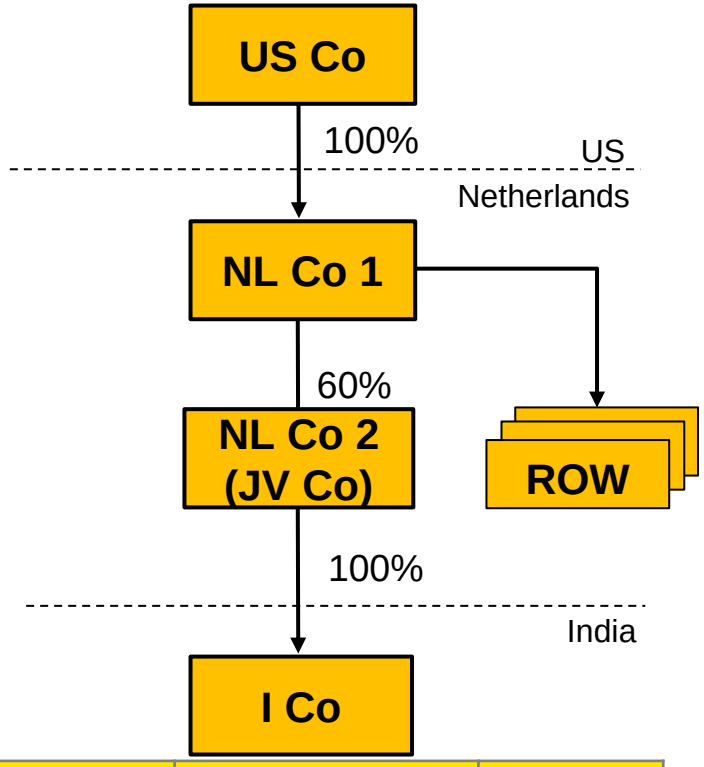
PPT and GAAR interplay

- Qua treaty benefit, PPT fulfilment essential
- If arrangement/ transaction is PPT tainted, treaty benefit is denied:
  - GAAR invocation may not be necessary for denying treaty benefit
  - GAAR may still re-characterise the transaction
- If arrangement passes PPT test, GAAR test most likely gets fulfilled
  - Main purpose test of GAAR is, if at all, stricter
  - S.97(1)(c) test likely to be passed as location/ residence is likely to be for substantial commercial purposes

Case Studies

Case study 1 - Inbound investment: PPT impact [Dividend and Interest]

Facts of the case

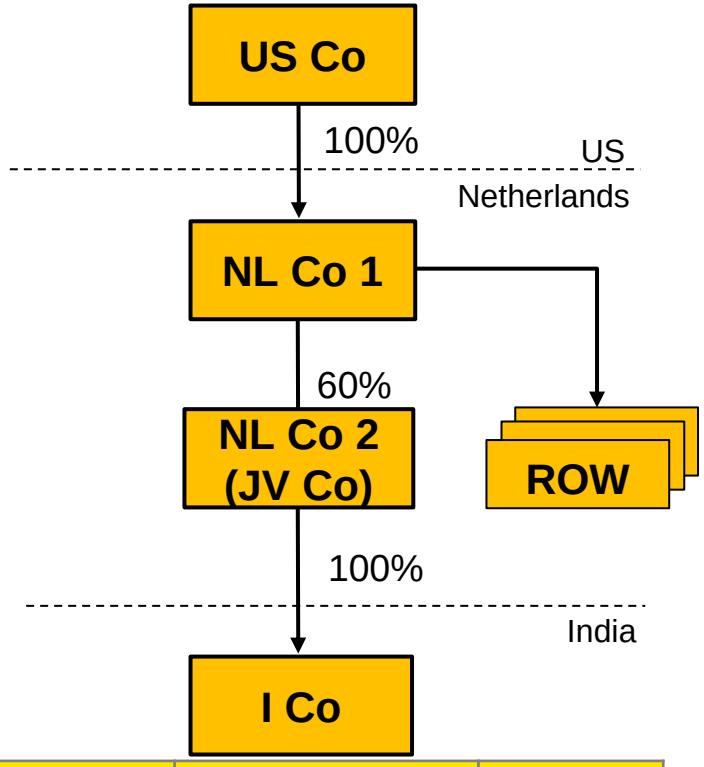


	Dividend	Interest
I-NL treaty	5% (Post MFN clause)	10%
I-US treaty	15% (≥ 10% shareholding) else 25%	15%
ITL	20%*	20%*

*Plus applicable surcharge and cess

- US Co is listed operating entity
- US Co has established regional headquartered company in NL for making investment in various EU and Asia Pacific jurisdictions
- NL Co 1 has significant substance, managerial staff and relevant infrastructure for supporting its presence and underlying investments
- NL Co 2 was established as JV Co for the purpose of investing in I Co
- NL Co 2 earns following streams of income:
  - Dividend income from I Co
  - Interest income from I Co
- NL Co 2 has valid TRC and claims to be BO of income
- India-NL treaty stands modified by MLI w. e. f. 1 April 2020
  - PPT and Preamble get inserted

Questions



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I-US treaty	15% (≥ 10% shareholding) else 25%	15%
ITL	20%*	20%*

*Plus applicable surcharge and cess

In the facts of the present case:

- Assuming NL Co. 1 has substance, while NL Co. 2 holds only I Co., does PPT analysis differ?
- Does PPT operate on “all or none approach” or is resort to I-US treaty a possibility?
- Whether an arrangement with object of obtaining benefits of many treaties, indicate that benefit under I-NL treaty is not one of the principal purpose of arrangement?
- Does PPT analysis change if formation of NL Co. 1 / NL Co. 2 is for primary purposes of US tax efficiency and India tax impact is relatively nominal?

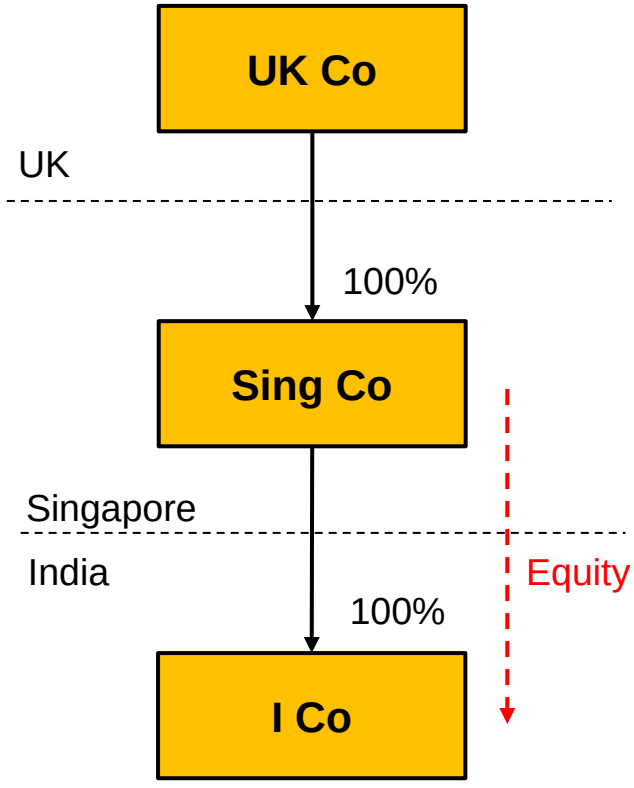
Does PPT operate on “all or none” approach?

Tax Authority’s contentions on applicability of domestic tax rate	Taxpayer’s contentions on applicability of India-USA treaty

▶ PPT applicable if NL Co2 has been established and maintained for one of the principal purpose to obtain lower WHT rate
▶ PPT has absolute effect of denial of treaty benefit on abusive transactions
▶ PPT works on ‘all or none’ approach; it does not look beyond I-NL treaty except under discretionary relief mechanism
▶ **India (as source state) has not opted for discretionary relief provision**
▶ **Deterrent effect of PPT will be diluted if taxpayer (NL Co2) is permitted to have consequential relief**
▶ As per OECD, ‘cliff effect’ impact addressed by specific discretionary relief provision
	▶ PPT leads to denial of ‘benefit’ from tainted arrangement
	  ▶ Meaning of ‘benefit’ suggests some improvement in condition
	  ▶ By implication suggests denial of “incremental favourable position” obtained due to tainted arrangement
	▶ PPT consequences cannot be harsher than domestic GAAR
	  ▶ Identification of tax benefit happens by comparison with ‘counterfactual’
	  ▶ Consequences should also be based on realistic counterfactual
	  ▶ A fair “counterfactual” in the case is to relate funding in I Co directly by US Co
	▶ Discretionary relief provision is an inbuilt good practice and indicator of fair play

Case study 2 - Inbound investment: PPT/GAAR impact [Capital gains]

Facts of the case



- Sing Co's investments in shares of I Co were made before 1 April 2017
- I-S protocol triggers ***source taxation***, if gains arise from alienation of shares acquired ***on or after 1 April 2017*** [Article 13(4B)]
  - Residence based taxation for shares acquired ***on or before 31 March 2017*** [Article 13(4A)]
- GAAR not to apply in respect of 'income from transfer' of investment made before 31 March 2017 [Rule 10U(1)(d)]
- Sing Co transfers certain shares before 31 March 2020 **(Tranche 1)**
- It is likely that balance shares will be transferred in 2021 **(Tranche 2)**
- Evaluate GAAR and PPT implications

Disposal of I Co shares post PPT - Issues

Assets of Sing Co	Acquisition	Disposal	GAAR applies?	PPT applies?
I Co shares **(Tranche 1)**	Pre April 2017	Pre March 2020	No	No
I Co shares (Tranche 2)	***Pre April 2017***	***In 2021***	***No***	***Yes (?)***

As regard to transfer of I Co shares (Tranche 2):

- Does PPT apply for investments made prior to MLI developments?
- Do special considerations apply for treaty grandfathered investments?
- Does s. 90(2A) support that PPT is not to be applied when GAAR is inapplicable?
- Is PPT threshold of one of the principal purposes far lower than main purpose test of GAAR?

Impact of PPT on treaty grandfathered investments

① **Alt 1:** PPT will not apply to Article 13(4A) which is introduced for grandfathering past investments

- Grandfathering ensures smooth transition and aligns with domestic GAAR
- Amended I-S treaty was in light of BEPS project and grandfathering was a conscious decision

② **Alt 2:** PPT applies to entire treaty including Article 13(4A) notwithstanding that acquisition of investment in I Co was on or before 31 March 2017

- PPT is a "non-obstante" provision and worded widely to cover all benefits
- PPT read with revised preamble will empower tax authority to deny tax benefit in treaty shopping arrangements

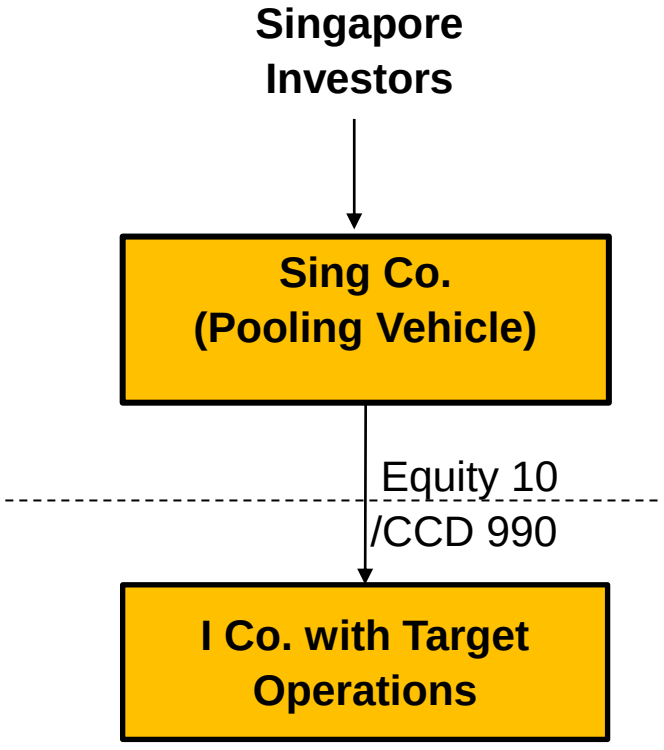
③ **Alt 3:** PPT applies to Article 13(4A) - however, availing grandfathering benefit is in accordance with ***object and purpose***

- Object and purpose of grandfathering provision is to avoid disruptive transition and provide certainty
- Providing certainty to taxpayers is one of the object and purpose of the treaty
- Grandfathering is an exception to the normal provision for applicability of treaty and its object may need to be respected

Grandfathering clause is an exemption that allows persons or entities to continue with activities or operations that were approved before the implementation of new rules, regulations, or laws

Case study 3 - Interplay of GAAR and PPT in choice of debt v/s. equity

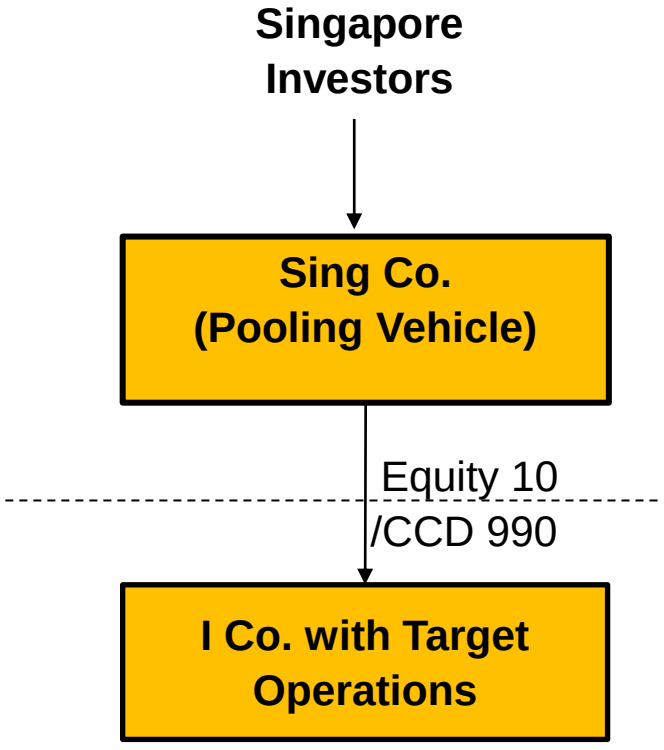
Facts



	I-S treaty	ITL
Interest	15%	40%
Dividend	10%	20%
Capital gain on CCD	Exempt	Taxable
Capital gain on shares	Taxable	Taxable

- Sing Co. is a pooling vehicle organised by fund managers of eminence and domiciled in Singapore
- Most investors in Sing Co. are Singapore residents
- Sing Co. satisfies “location test”
- Sing Co sets up I Co and infuses Equity of 10 and CCD of 990
- I Co acquires capital intensive business by investing 1000
- Annually, I Co. pays CCD interest to Sing Co. while dividend pay out unlikely in foreseeable future – primarily due to book losses on account of depreciation

Issues



	I-S treaty	ITL
Interest	15%	40%
Dividend	10%	20%
Capital gain on CCD	Exempt	Taxable
Capital gain on shares	Taxable	Taxable

- Whether PPT/GAAR can deny treaty benefit on CCD interest received by Sing Co. on grounds that:
  - Object is to achieve tax efficiency as I Co. also entitled to interest deduction
- Whether PPT can re-characterise debt as equity?
- Focus of case study: PPT and its ambit and its interplay with domestic GAAR

Commercial reasons supporting choice of CCD over equity (Reasoning being common to GAAR/PPT)

- By nature, any large size project in the infrastructural sector is, over the globe, highly leveraged
  - Industry norm may itself be 75-80% of debt
- Funds pooled from various unrelated investors is, in essence, pooling by debt oriented fund
  - Investors (or rather financiers, in the present case) look at regularity of returns; safety; more than capital appreciation
- Flexibility of servicing investments in spite of huge depreciation cost within fold of SPV
  - Equity infusion carries constraint of ‘distributable profit’
  - Avoids cash trap and retains attractiveness; viability and long-term sustainability
- Compliance of s.94B (w. r. t. EBITDA) reflects parameters agreed by India to control interest deduction limitation
- Choice principle supported by CBDT Circular, Shome Committee Report etc

PPT and GAAR interplay

- GAAR may be invoked :
  - GAAR may re-characterise the instrument or re-attribute the income
  - S.98(2)(i) may re-characterise debt as equity

"To the extent that the application of the (domestic) rules results in a re-characterization of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes…" (Para 79 of 2017 OECD Commentary)

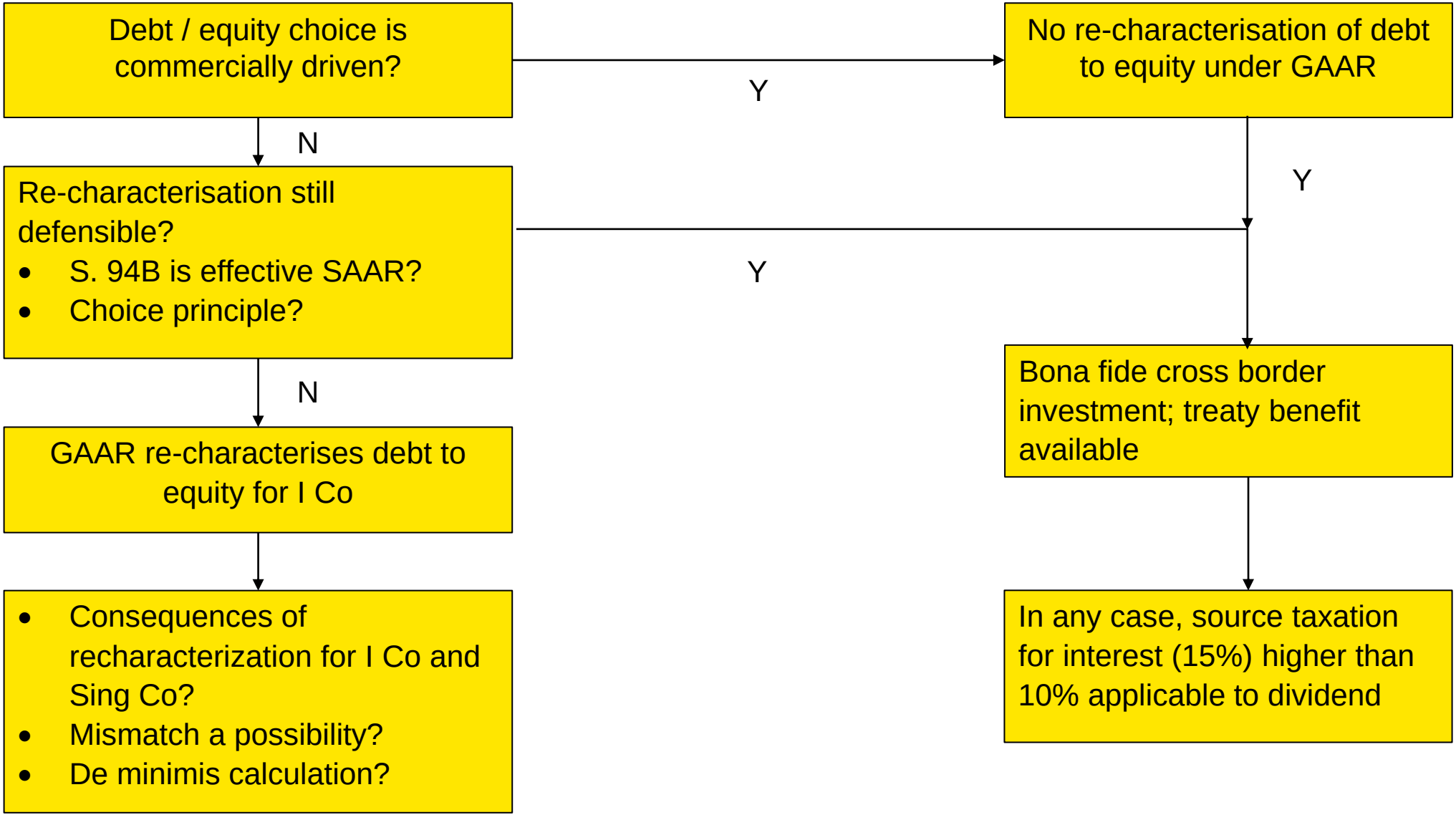
PPT and GAAR interplay

- Qua treaty benefit, if PPT triggered, GAAR invocation academic
- If PPT is triggered
  - PPT denies merely treaty benefit
  - PPT cannot recharacterize debt for I Co.; PPT cannot deny interest cost

…application of the PPT does not and is not intended to result in a re-characterisation of arrangements or transactions that directly or indirectly resulted in a treaty benefit… (IFA 2018 OECD Report[1])

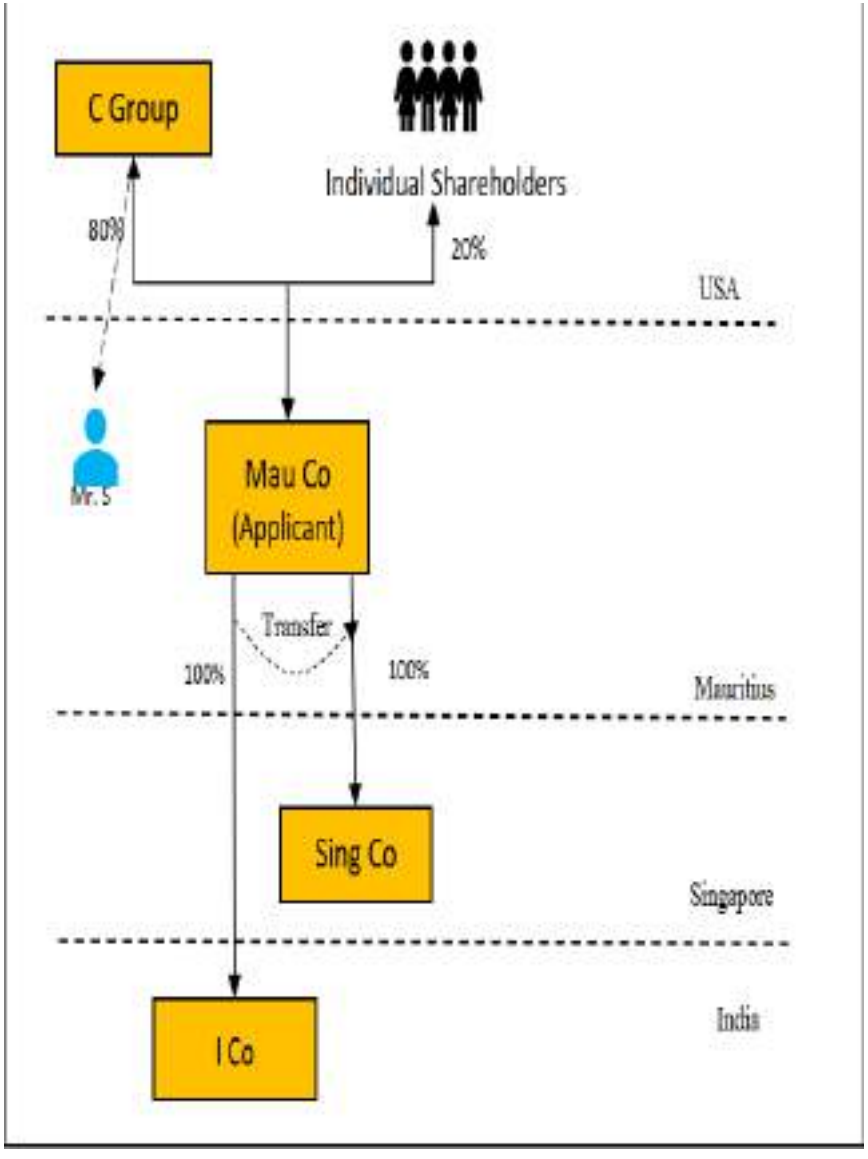
[1] By Edward Barret and Maikel Evers (advisors to OECD Centre for Tax Policy and Administration)

PPT and GAAR interplay



Judicial Precedents

AB Mauritius (2018) (402 ITR 311) (AAR) - Negative



Facts

- Mau Co. (Applicant) is a tax resident of Mauritius and was formed as an investment company to invest in APAC region
- It acquired shares of I Co from third party US Companies. The SPA was signed by Mr. S, an authorized signatory, representing the promoter group and being fully authorized by the board of the Applicant. These shares were taken over along with a liability which the sellers had payable to the 'C' Group as per the loan agreement.
- Subsequently, the Applicant proposed to transfer shares of I Co to Sing Co (a subsidiary of Mau Co) in consideration for shares of Sing Co. For business and commercial reasons, Sing Co was proposed to function as holding company and to invest in APAC region.

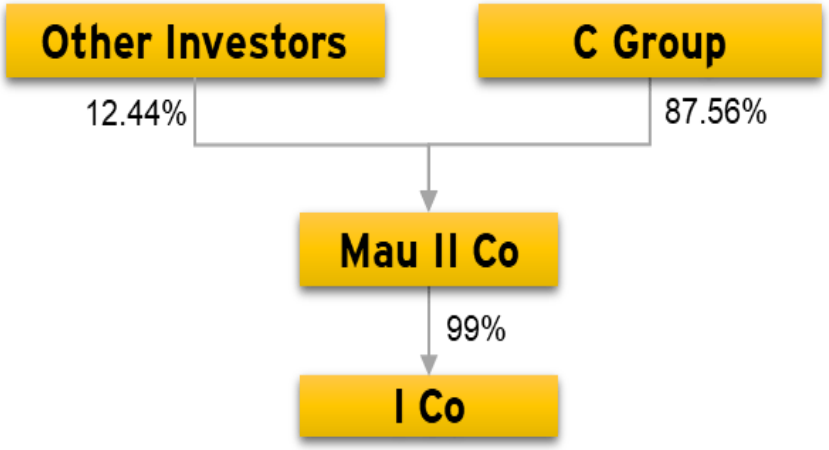
AB Mauritius (2018) (402 ITR 311) (AAR)

AAR Ruling

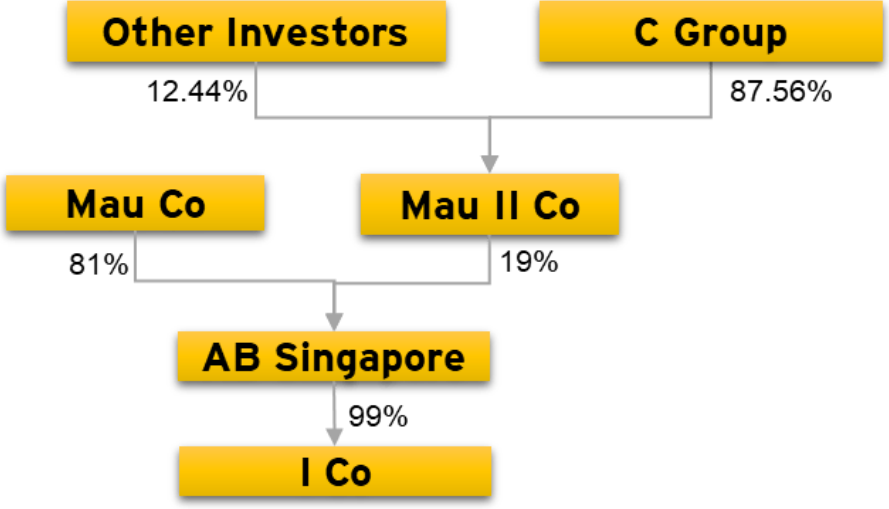
- The AAR held that the Applicant was not entitled to claim benefit under Article 13 of India-Mauritius DTAA. Income was taxable in the hands of C Group as per India-US DTAA.
- The AAR held that the Applicant was merely interposed to acquire shares of I Co and was a benami/ name lender in the transaction. The transaction was in substance executed by C Group.
- The BoD of the Applicant were merely informed about the investment in ICo after the transaction had taken place and the BoD ratified the decisions. The BoD were neither managing nor controlling crucial investment decisions and acted as a puppet in the hands of holding company
- Although, TRC obtained by the Applicant acts as a presumptive evidence of beneficial ownership as per CBDT Circular No.789, the subsequent conduct of Mau Co casts a shadow on whether it could be said to be the beneficial owner of the shares acquired through the SPA, which was neither signed by it nor mentions any consideration paid or payable by it
- A subsidiary has separate and independent status as compared to its parent company. However, in the present case, the companies are acting together, as 'C' Group's director signed SPA on behalf of Mau Co, without formally being on the Board and moving consideration to the convenience of the whole group, it can hardly be said that they are separate entities in substance

AB Holdings Mauritius II (AAR No. 1129 of 2011) - Positive

Structure



Post Acquisition in 2012



Facts

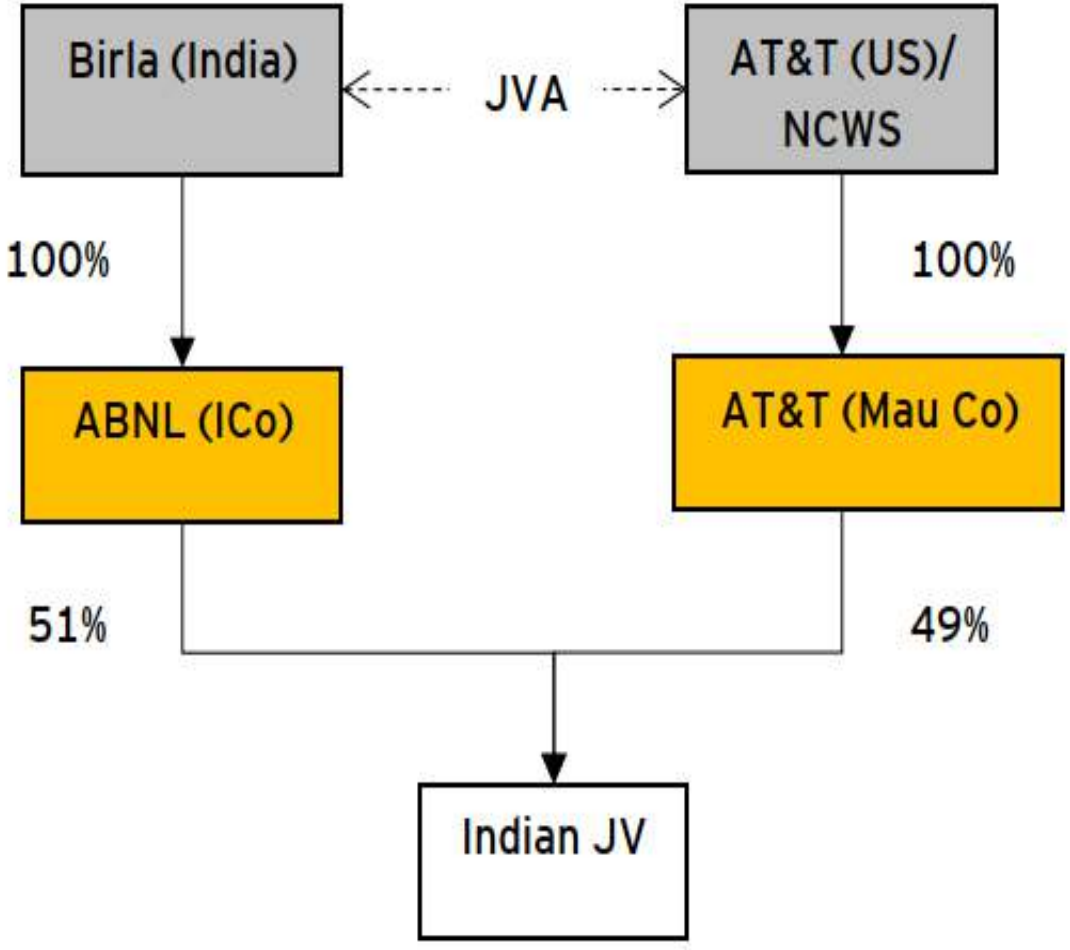
- AB Mauritius II (Mau II Co), incorporated in 2008 as a part of C Group, invested in AB International, an Indian Company (I Co)
- Sole purpose of incorporation was to invest in 'S' sector in India and other Asian markets
- Mau II Co's business is managed by 3 directors out of which 2 were residents of Mauritius at the time of making such investments
- SPA was executed by the director of Mau II Co and the considerations were linked through banking channels
- In August 2011, AB Singapore was incorporated as a group company of Mau II Co
- In 2012, Mau II Co has divested its investment in I Co to AB Singapore

AB Holdings Mauritius II (AAR No. 1129 of 2011)

AAR Ruling

- The AAR held that Mau II Co was a beneficial holder of I Co shares and the investment decisions and its affairs were not controlled by C group based on the following factors
  - Transfer was done as a part of re-organisation indicating long term business and commercial purpose
  - Investment in I Co is not an overnight or short-term transaction (as it was for seven years)
  - Having regard to the nature of business, not many employees are required for their operations
  - Directors were well qualified to engage in meaningful discussions with reference to the Mau II Co's business
  - Signature of directors on documents pertaining to additional investment and restructuring, etc. indicates key decisions were taken by them
  - References of AAR's rulings in case of Vodafone, Ardex, E-trade and JSH Mauritius to rule that Mau II Co is an independent legal entity and the money received from holding company was immaterial
- Basis the above, AAR concluded that Mau II Co will be eligible to claim treaty benefits and capital gains would be exempt under Article 13 of the India-Mauritius DTAA

Aditya Birla Nuvo Ltd (342 ITR 308) (Bombay HC)



Aditya Birla Nuvo Ltd (342 ITR 308) (Bombay HC)

Facts

- Birla Group entered into a Joint Venture Agreement ("JVA") with a AT&T (USA) to enable it to carry out wireless telecommunication business in India
- Pursuant to JVA, the AT&T (USA) obtained 49% stake in Idea (Indian JV), balance 51% being held by Birla Group
- 49% of Idea was held by Mauritius group entity of AT&T (USA) i.e. AT&T Mauritius and 51% was held by Aditya Birla Nuvo Ltd. (ABNL) on behalf of Birla Group
- JVA closure was executed between Birla Group and AT&T Mauritius, even when AT&T Mauritius was not party to the JVA. AT&T Mauritius though not being obligor, paid the liability for holding the shares of Idea under JVA
- New Cingular Wireless Services Inc. USA (NCWS) acquired AT&T (USA)
- NCWS decided to exit the venture. ABNL, exercising the first right of refusal in SHA, purchased the shares of Idea from AT&T Mauritius
- AT&T Mauritius immediately repatriated the amount to NCWS (its parent company) as dividends and loan repayments
- Subsequently, notice was issued to ABNL seeking to assess them as representative assessee basis that AT&T (US) was the beneficial owner of shares of Idea and not AT&T Mauritius thereby denying treaty benefits
- A writ petition was filed by ABNL against the above contention

Aditya Birla Nuvo Ltd (342 ITR 308) (Bombay HC)

Held

- The HC held that under the JVA, AT&T (US) had the obligation to subscribe to shares of Idea. The shares were merely allotted in name of AT&T Mauritius for convenience; the exercise of all the rights in relation to shares continued to vest in NCWS/ AT&T (US)
- The SHA mentioned that the group entity in whose favour the shares are issued/ transferred shall name AT&T (US) as its representative to exercise all rights/ obligations attached to the shares except for obligation to pay. Thus, such payments by AT&T Mauritius were held to be on behalf of AT&T (US), without impacting ownership of AT&T (US)
- The decision of transferring shares could not be taken by AT&T Mauritius on standalone basis. The consent of AT&T (US) for such sale was non-negotiable
- It was pursuant to the JVA that the ownership rights were with AT&T (US) and the fact that RBI had granted approval to allotment of shares in the name of AT&T Mauritius does not matter
- Holding of a valid TRC by AT&T Mauritius was irrelevant
- Also, on the fact that the receipts from AT&T Mauritius were dividend and loan repayments, the Court held that it was AT&T (US) obligation to pay for shares and if it discharged that liability by advancing loan to AT&T Mauritius and causing it to pay, then one has to look at the real transaction.

Tiger Global International II Holdings *(together with other applicants)* ***[2020] 116 taxmann.com 878 (AAR - New Delhi)***

- The AAR in this case held that the control and management of the Taxpayers was located outside Mauritius and therefore, Taxpayers were see-through entities whose ultimate owner and beneficiary was a US resident.
- Although it was argued that mere authorization to operate a bank account does not suggest that the person so authorized has control over the funds, however, where such authorized signatory of tax payer as well as the parent company is same cannot be mere co-incidence.
- The **Taxpayer companies were only a "see through entity" set up to avail the benefits of India-Mauritius Tax Treaty as Taxpayer's funds were ultimately controlled by authorised signatory.**

Concluding thoughts

- **Błażej Kuźniacki -** World Tax Journal, 2018 (Volume 10), No. 2

  "One of the basic functions of tax treaties seen in light of the rule of law is to guarantee certainty for taxpayers engaged in international commerce enabling them to predict the tax-related implications of their cross-border activities. The vagueness of the PPT and the wide discretion it hands to tax authorities endanger this function of tax treaties. In an extreme scenario, it may undermine the very rationale for entering into tax treaties, that being to enhance international commerce. ***One might say that the introduction of the PPT has the potential to mirror the treaty abusive practices of taxpayers. Just as taxpayers abuse tax treaties through their treaty shopping practices, so too may tax authorities by applying the PPT.****"*

Questions?

Thank You!