# NATIONAL LAW SCHOOL OF INDIA UNIVERSITY

# BANGALORE


***"Double taxation avoidance agreement; in special reference of agreement between India and Mauritius"***

**DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF LL.M. (Business Law)**

**UNDER THE GUIDANCE OF**

**Dr. (Prof.) N.L. Mitra**

**SUBMITTED BY:**
**Satyadeep Kumar Singh.**
**I.D. No. 336**
**2010**

## Certificate

This is to certify that the dissertation titled *"Double taxation avoidance agreement; in special reference of agreement between India and Mauritius"* submitted by Satyadeep Kumar Singh (ID No. 336) in the partial fulfillment of the requirements of the Degree of Master of Laws (LL.M) of the National Law School of India University is the product of bonafide research satisfactorily carried out by him under my guidance and supervision.

Date

Place

Prof. N. L. Mitra
(Professor of Law)

# Declaration

I, the undersigned hereby declare that the work titled as *"Double taxation avoidance agreement; in special reference of agreement between India and Mauritius"* is the outcome of research carried out by me under the guidance and supervision of Professor N.L.Mitra at National Law School of India University, Bangalore.

I further declare this work is original, except for such assistance, taken from the sources, as have been referred to or mentioned at the respective places and for which necessary acknowledgements have been made.

I also declare that this work has not been submitted either in part or in whole for any Degree or Diploma at any other university.

Date 19.06.2010

Place NLSIU, Bangalore.

Satyadeep Kumar Singh

Satyadeep Kumar Singh
ID No.336
IInd Year LL.M
(Business Law)
National Law School of India University
Bangalore.

# Acknowledgement

I would like to thank a few people who have helped and inspired me, who have been instrumental in the completion of my dissertation. I extend my gratitude to my respected teacher and guide, Prof. N.L.Mitra for his valuable guidance and finding me eligible to research under his guidance.

My deepest gratitude goes to my family for their love and support throughout my life, this dissertation would have been impossible without them. I also express my gratitude to other faculty members, library staff and other staff members of NLSIU, Bangalore for their help and cooperation. I am deeply thankful to my friends for their support and inspiration to name a few and to everybody who has been part of my life and has been there for any help and support in this endeavor and I failed to mention, thank you very much.

Above all, thanks to almighty for blessing my life and guiding me.

Thank You

Satyadeep Kumar Singh

Satyadeep Kumar Singh.

# GENERAL CONTENTS


*List of cases* *I*
*Abstract* *III*
**A. Introduction.** *VI*
**B. Research methodology and Chapterisation.** *VIII*

**CHAPTER.1: The History and development of Tax treaties and Model Conventions.** **1**

**CHAPTER 2: Tax treaties and convention: purpose, use and status** **6**

2.1 Purpose of Double Taxation Conventions 6
2.2 Relationship of Tax Treaties and Domestic Law 9
2.3 Treaty Shopping 12

**CHAPTER 3: Tax Treaty Interpretation and Jurisprudence.** **15**

3.1 The Vienna Convention on the Laws of Treaties 15
3.2 Reference to the OECD Commentaries 17
3.3 The Interpretation Rule of Article 3(2) of the OECD Tax Model Convention 19
3.4 Conflicts of Qualification. 22

**CHAPTER 4: Basic contents of Model Tax Treaty.** **25**

4.1 Coverage and Scope 25
4.2 Income from Immovable Property 27
4.3 Business Income 28
4.4 Dividends, Interest and Royalties 32
4.5 Employment and Pension Income 35
4.6 Capital Gains and the "Other Income" Article 39
4.7 Non-Discrimination. 42
4.8 Mutual Agreement Procedure, Exchange of Information and Assistance in the Collection of Taxes. 45

**CHAPTER 5: Indo- Mauritius DTAA: saga of use and misuse** 49

5.1 Facts and figures in regard of Indo- Mauritius DTAA 49
5.2 Indo- Mauritius DTAA and FDI in India 52
5.3 DTAA and Income Tax Act 53
5.4 Provisions of Agreements leading to make Mauritius, a tax haven. 61
5.5 Mauritius legislations and their impact: Offshore Business Activities Act 1992 (MOBA Act 1992), Financial Services Development Act 2001 65
5.6 Interpretation of Indo- Mauritius DTAA under Azadi Bachao Andolan case: Trappings of round tripping. 68

5.7 Legislative Act v. circular under the Act
5.8 Effect and Critical Analysis of Azadi Bachao Andolan Case. 72
5.9 Summary of Interpretation. 75

**CHAPTER 6: Impact of New proposed tax code on Indo-Mauritius and other DTAAs** 77

**CHAPTER 7: Final Thought** 97

**BIBLIOGRAPHY** 99

**ANNEXURE: (CONVENTION BETWEEN INDIA AND MAURITIUS FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES OF INCOME AND CAPITAL GAINS.)** 106- 124

# List of Cases

- CIT v A. Raman & Co. (1968) 67 ITR 11 (SC)
- McDowell & Co. Ltd. 2002-TIOL-40-SC-CT
- Shiva Kant Jha's Case & Anr v. Union of India & Anr. 2003-TIOL-04-HC-DEL-IT
- UOI vs. Azadi Bachao Andolan(2003) 263 ITR 706
- Porrits & Spencer (Asia) vs. CIT (P&H High Court) 2000 241 ITR 126 P H
- M.V. Vallipappan and others v. ITO, 170 ITR 238
- Assistant Commissioner of Income-tax v. Velliappa Textiles & Ors (2003) 11 SCC 405)
- Commissioner of Customs, Calcutta v. Indian OIL Corporation Ltd 2004 (165) E.L.T. 257 (S.C.)
- Ostime (Inspector of taxes) v. Australian Mutual Provident Society (1960) 39 ITR 210 (HL)
- Bengal Iron Corporation v. C.T.O. — 1993 (66) E.L.T. 13 (S.C.)
- Collector v. Dhiren Chemicals Industries — 2002 (139) E.L.T. 3 (S.C.)
- Collector v. Dhiren Chemicals Industries — 2002 (143) E.L.T. 19 (S.C.)
- Collector v. Jayant Oil Mills (P) Ltd. — 1998 (100) E.L.T. 10 (S.C.)
- Collector v. Kores India Ltd. — 1997 (89) E.L.T. 441 (S.C.)
- Collector v. Usha Martin Industries — 1997 (94) E.L.T. 460 (S.C.)
- C.S.T. v. Indra Industries — (2000) 9 SCC 66
- Ellerman Lines Ltd. v. Commissioner of Income Tax — AIR 1972 SC 524
- Garden Silk Ltd. v. U.O.I. — 1999 (113) E.L.T. 358 (S.C.)

- Hindustan Aeronautics v. Commissioner of Income Tax — 2000 (119) E.L.T. 513 (S.C.)
- Keshavji Ravji & Co. v. Commissioner of Income Tax — (1990) 2 SCC 231
- K.P. Varghese v. Income Tax Officer — AIR 1981 SC 1922
- Navnit Lal C. Jhaveri v. K.K. Sen — AIR 1965 SC 1375
- Panchmahal Steel Ltd. v. Collector — 1998 (101) E.L.T. 399
- Paper Products Ltd. v. Collector — 1999 (112) E.L.T. 765 (S.C.)
- Ranadey Micronutrients v. Collector — 1996 (87) E.L.T. 19 (S.C.)
- Simplex Castings Ltd. v. Commissioner — 2003 (155) E.L.T. 5 (S.C.)
- Sirpur Paper Mills Ltd. v. Commissioner of Wealth Tax — (1970) 1 SCC 795
- U.O.I. v. Azadi Bachao Andolan — 2003 (8) SCALE 287, 308
- U.S. v. Attantic Refining Co. — 112 F Supp. 76, 80
- Pahwa Chemicals Pvt Ltd vs the Commissioner of Central Excise 2005 AIR 1532, 2005(2 )SCR380 , 2005(2 )SCC720 , 2005(2 )SCALE358 , 2005(11 )JT21)

# ABSTRACT

Since the end of the 19th century, individual states have entered into bilateral conventions for the avoidance of double taxation. Double taxation may arise when the jurisdictional connections, used by different countries, overlap or it may arise when the taxpayer has connections with more than one country. A person earning any income has to pay tax in the country in which the income is earned (as source Country) as well as in the country in which the person is resident. As such, the said income is liable to tax in both the countries. To avoid this hardship of double taxation, Government of India has entered into Double Taxation Avoidance Agreements (DTAA's) with various countries. DTAA's provide for the following reduced rates of tax on dividend, interest, royalties, technical service fees, etc., received by residents of one country from those in the other. India and Mauritius has a DTAA between them and has been controversial in recent year due to treaty shopping.

Briefly touch upon the historical importance of Mauritius in the context of total foreign direct investments in India, Mauritius tops the list with a 44% during the period lasting April 2000 to April 2009 (in contrast, Singapore stands at 9% and the U.S. at 7%). With a difference of 35 percentage points between the top two spots and Mauritius not being an investing country in its own right, it is anybody's guess that Mauritius has been used as a holding company jurisdiction for making investments in India with actual investors being tax residents of countries outside Mauritius. The reasons for using Mauritius are simple: India has a tax treaty with Mauritius providing that gains on any transfer of shares in an Indian company by the Mauritius holding company shall not be taxable in India but in Mauritius as per the domestic tax laws in Mauritius. Domestic tax laws in Mauritius do not tax capital gains. Therefore, any transaction on account of

the transfer of shares in an Indian company by a Mauritius holding company is a tax free transaction both in India and Mauritius.

The Indo-Mauritius tax treaty was unsuccessfully challenged in the famous case of *Union of India v. Azadi Bachao Andolan and Anr. (2003).* The following principles were expounded by the Indian Supreme Court in its decision:

• An important principle that needs to be kept in mind in the interpretation of the provisions of the international treaty, including one for double taxation relief, is that treaties are negotiated and entered into at a political level and have several considerations as their basis. The main function of a treaty should be seen in the context of aiding commercial relations between treaty partners and as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect of income "falling to be taxed" in both jurisdictions.

• The principles adopted in the interpretation of treaties are not the same as those in the interpretation of statutory legislation.

• There is nothing like equity in a fiscal statute. Either the statute applies or it does not. There is no question of applying a fiscal statute by intendment if the expressed words do not apply. If it was intended that a national of a third State should be precluded from the benefits of the treaty, then a suitable term of limitation to that effect should have been incorporated in the treaty.

• In a fiscal economy, certain evils like treaty shopping are tolerated in the interest of long term development. Perhaps it was intended at the time the Indo-Mauritius treaty was entered into. Whether it should continue and, if so, for how long, is a matter that should best be left to the discretion of the executive as it is dependent upon several economic and political considerations.

The court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. With India losing significant tax revenue due to the treaty's application, the clear option available to India's government was to renegotiate the tax treaty with Mauritius - especially the article on capital gains. The government apparently did try but without success. Meanwhile Mauritius decided to more strictly enforce the substance requirements under its domestic law for companies to be tax resident in Mauritius and entitled to the benefits of the Indo-Mauritius treaty. The debatable option has been whether India can change its domestic law to unilaterally nullify the effect of the treaty. The new draft Direct Taxes Code Bill, 2009 appears to be just such an attempt. The following proposals in the draft Code may potentially impact the operation of all the tax treaties India has entered into, including that with Mauritius:

**A.** Specific legislation to the effect that the preference of the applicability of a tax treaty or the domestic tax law would depend upon the enactment, which is later in time, as compared to the existing provisions that a taxpayer could choose to be governed by either a tax treaty or the domestic tax laws, depending upon whichever was more favorable to it; and

**B.** Introduction of general anti avoidance rules (GAAR), which has been referred to in the explanatory statements of the Tax Code, as to also partake of the nature or character of "treaty override

Assuming the new Direct Taxes Code comes into effect, the use of Mauritius as a holding company jurisdiction for India appears fraught with controversy. Because provisions under the new Direct Taxes Code would be later in time, they may prevail over the Indo-Mauritius tax treaty (and other treaties).

# A. INTRODUCTION

A very recent controversy of The Indian Premier League (IPL) alleged to have a secretive ownership via Mauritius rout of at least one of the eight teams in IPL brought back The India Mauritius tax treaty in lime light under political and financial discussion.[1] IPL contributed only an episode as the said treaty has already been under constant fire in India since a decade.

To understand the legal obligations and implications it is imperative to understand such treaties under International Legal framework. Tax treaties are international agreements entered into by countries by countries and hence subject to general international law on treaties as codified in the Vienna Convention on the law of treaties.[2] Actually they can be seen as having a dual nature. On the one hand, Double taxation conventions are international agreements entered into between the governments for the allocation of fiscal jurisdiction. On the other hand they become part of the tax law of each contracting state, whether by direct incorporation into the domestic law or by enactment into that law. Most tax treaties are bilateral, that is they involve two countries only and cover income and capital taxes, though there are some examples of multilateral tax treaties[3]. The number of bilateral tax treaties currently in force exceeds 2,500 and the number is growing. In fact, the importance of tax treaties has increased significantly in recent years as a consequence of the globalization of economy and the liberalization of cross border trade and business. The majority of these treaties are based on the Model Convention drafted by the Organization for Economic Cooperation and Development (OECD)[4] which is now revised on a regular basis

[1] The Tribune, April 21, 2010, Chandigarh

[2] The Vienna Convention on law of Treaties of 23rd May 1969. This came into effect on 27th Jan 1980. It codifies existing norms of customary international law.

[3] The Nordic Convention on income and capital entered into by Denmark , Finland, Iceland, Norway , Sweden and concluded in 1983 and repealed in 1987 .

[4] OECD, Model Tax Convention on Income and on capital, Paris, looseleaf ed. Last amendments in Jan. 2003.

which, by eliminating international double taxation, promote exchange of goods, persons, services and investment of capital. These are bilateral economic agreements where the countries concerned evaluate the sacrifices and advantages which the treaty brings for each contracting state, including tax forgone and compensating economic advantages. The interaction of two tax systems each belonging to different country, can result in double taxation. Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of taxable entity, maintenance of Permanent Establishment and so on. Double Taxation of the same income in the hands of same entity would give rise to harsh consequences and impair economic development. Double Taxation Agreements between two countries therefore aim at eliminating or mitigating the incidence of double taxation.

# B. RESEARCH METHODOLOGY

## (a) Hypothesis

International bilateral tax treaties which are basically to avoid double taxation among two nations have International Legal framework. Double taxation avoidance agreement between India and Mauritius has been a subject of constant treaty shopping since more than a decade. To avoid such treaty shopping provisions under new proposed tax code by government of India has made an effort to dominate the International obligations by domestic law and need to reconcile.

## (b) Research Objectives:

- To evaluate the position of International tax treaties under International legal framework.
- To evaluate the historical background of International Tax treaties,
- To evaluate the mechanism and different ways of tax evasions under different models of Double taxation avoidance agreement,
- To evaluate the domestic as well as International legal status of tax treaty between India and Mauritius and mechanism of treaty shopping as used there under and,
- To evaluate the effect and prospect of new tax code over India Mauritius DTAA.

## (c) Research Questions:

1. What is the meaning and what are general contents of International Tax treaties and what has been the history behind these?

2. What is the International legal framework available for bilateral tax treaties and their interpretations, how such treaties have been used and misused for Treaty shopping?

3. What is the legal framework of India- Mauritius Double taxation avoidance agreement, what has been the role of Indian judiciary in interpreting the agreement?

4. How, India- Mauritius Double taxation avoidance agreement is being used for treaty shopping purpose and what can be the role of proposed new tax code in this regard?

## (d) Research Methodology:

Descriptive and analytical research methodology has been used in this research work.

**(e) Research Data:**

Information and data for the research has been collected through review of literature from both primary and secondary sources. Primary sources used herein are Statutory Enactments, Secondary Sources used are Text Books, Journals and online research database. Prominence has been given to various books and Articles along with international and national documents. Also online research database has been used.

## (f) Mode of Citation

Following manner of citation has been employed;

- Books – Name of the author, Title of the book, edition, publisher, place, Year, page number.
- Journals – Name of the Author, Title of the Article "Journal Name " , Vol., Year, Page number.

- Internet Sources – [Full URL].

This uniform method of citation has been followed throughout the paper.

## (g) Chapterisation

The **first chapter** is called The History and development of Tax treaties and Model Conventions which deals with historical perspective of International taxation treaties and development of different models of such treaties.

The **second chapter** makes a study into Tax treaties and conventions their purpose, use and status under which purpose of Double taxation Conventions, its relationship with Domestic Laws and concept of treaty Shopping has been dealt with.

The Third chapter addresses the Interpretation and Jurisprudence of Tax Treaties under which possible interpretations of tax treaties under Vienna Convention on the Laws of Treaties and in Reference to the OECD Commentaries, The Interpretation Rule of Article 3(2) of the OECD Tax Model Convention and the conflicts of Qualification has been dealt with.

The **fourth chapter** brings out the basic contents of Model Tax Treaties dealing with Coverage and Scope under which its status in regard of different heads like, Income from Immovable Property aspect, Business Income, Dividends, Interest and Royalties, Employment and Pension Income, Capital Gains and the "Other Income" Article, Non-Discrimination, Mutual Agreement Procedure, Exchange of Information and Assistance in the and Collection of Taxes.

The **fifth chapter** makes a study on the core issue of the research specifically Indo- Mauritius DTAA and its use and misuse as treaty shopping. Covering facts and figures in regard of Indo-Mauritius DTAA, Indo- Mauritius DTAA and FDI in India, DTAA and Income Tax Act, Provisions of Agreements leading to make Mauritius, a tax haven, Mauritius legislations and their impact, Interpretation of Indo- Mauritius DTAA under Azadi Bachao Andolan case, where Legislative Act v. circular under the Act was under the challenge and finally the effect and Critical Analysis of Azadi Bachao Andolan Case.

The **sixth chapter** explains the Impacts of New proposed tax code (2009) on Indo-Mauritius and other DTAAs and assessment of its legality under international legal framework.

## (h) Bibliography

This provides the Key to the primary and secondary sources used in the course of this research including Primary Sources list of statutes, secondary Sources Text Books, journals and Internet research database.

# CHAPTER 1

# THE HISTORY AND DEVELOPMENT OF TAX TREATIES AND MODEL CONVENTIONS

## 1.1 History

Since the end of the 19th century, individual states have entered into bilateral conventions for the avoidance of double taxation. At first only federally related or closely allied states were involved, e.g conventions were concluded between Prussia and Saxony regarding direct taxes on 16 April 1869 between Austria and Hungry concerning the taxation of business profits on 18 December 1869 and between Austria and Prussia regarding avoidance of double taxation on 21 June 1899. After the First World War a number of tax treaties were concluded and an extensive treaty network developed in Europe.

## 1.2 Development of double taxation agreement models

Being Agreements between two contracting states it was found that it would be useful to have a Model Agreement which could be the basis for discussion between two states contemplating to conclude a Double Tax Avoidance Agreement. The problems relating to double taxation are by and large common, with few of them being peculiar to particular tax situation in a country. To have a model for tax convention (agreement) was thought a desirable necessity so that such model could provide a frame for the drafting of a particular agreement. Model forms for the convention applicable to all countries were first prepared by the Fiscal Committee of the League of Nations in 1927. Later the said Committee conducted meetings in Mexico during 1945 and in London in 1946 and proposed minor variations.[1]

The League of Nations first commenced work in this behalf in 1921 and produced in 1928 the first

[1] League of Nations, *Fiscal Committee: Report on the Work of the Tenth Session of the Committee, held in London from March 20th to 26th, 1946* (C.37.M37.1946.II.A), page 8.

Model Bilateral Convention. These were followed by the Model Convention of Mexico (1943) and the London Model Convention (1946). The Council of the Organisation for European Economic Co-operation, which later became the Organisation for Economic Co-operation and Development (OECD) set up a fiscal committee in 1956 to formulate a Model Convention. The first draft Double Taxation Convention on income and capital was framed in 1963. This ultimately gave birth to the 1977 OECD Model Convention and Commentaries. On the basis of the recommendation of the Committee on Fiscal Affairs, OECD published the 1992 Model Convention in a loose leaf format to facilitate updating. The present Model Convention and Commentaries are updated as of January 2003.[2]

Today's tax treaties between industrialized countries and the structure of those treaties are to a large extent influenced by the work of the financial Committee and the Fiscal Committee of the Leauge of nations which was continued by the Fiscal Committee of the Organization for European Economic Co operation and the fiscal Committee of the OECD. Indeed the first structured study of the economic consequences of double taxation and the principles of international competence in taxation was conducted by a group of four economists and contained in the report on double taxation which was presented to the Financial Committee of the League of Nations in 1923[3].

To encourage further progress, the council of the League of Nations appointed a standing committee on taxation in 1928, which is the following year drafted two competing model treaties. A subcommittee, which due to the advent of the Second World War was composed primarily of representatives from Latin American countries, drafted the model treaty of Mexico in 1943; this was

---

[2] A "GLOBAL CHARTER"/"LEGAL STANDARD" AN INVENTORY OF POSSIBLE POLICY INSTRUMENTS, PRELIMINARY, AS OF 19th March 2009, (A joint stock-taking exercise coordinated by: Organisation for Economic Co-operation and Development) OECD,

[3] Report on double taxation submitted to the Financial committee by Professor Bruins , Einaudi, Seligman and Sir Josiah Stamp, Leauge of Nations Doc. E.F.S 73 .F.19 (Geneva 1923) p.36.

followed in 1946 by the London Model Treaty in the drafting of which industrialized States were able to participate and to bring their views to bear.[4] Both draft conventions taxpayers of the contracting states, but in fact restrict their application to persons having their fiscal domicile in one of the contracting states.

The efforts of the OEEC and its successor, the OECD, picked up where the preparatory research of the League of Nations had left off, to develop a system for the avoidance of Double taxation.

The Committee on Fiscal Affairs (which was formed in 1956) submitted a series of model treaty articles in four interim reports between 1956 and 1961 and a summary report in 1963 to which the complete model treaty and an official commentary were appended. To the extent the OECD Member States did not wish to follow particular recommendations in the model convention they entered their reservations in the commentaries. Aside from the reservations, a number of Member States include observations; these observations do not express any disagreement with the text of the Conventions, but furnish a useful indication of the way in which those countries will apply the provisions of the Article in question. The 1963 Model Convention was revised in 1977, and recently updated in 1992, and subsequently in 1994, 1995, 1997, 2000 and 2003.

It must be borne in mind that the Model Convention is only a recommended format with no legal biding force either at the international or national level. It is simply a document concluded by an international organisation, and its use is discretionary, not mandatory. However, the members of the OECD largely use the OECD Model as a basis for negotiating their double taxation conventions.

It is noteworthy that certain countries have developed their own models for negotiation; these models are based largely on the OECD Model. The Netherlands, for example, has published its

[4] London and Mexico Model Tax convention , Commentary and text , League of Nations Doc. C 88. M 1946. II.A (Geneva 1946) Art. I of the Protocol.

Model.[5] The United States Treasury published a Model in 1977 and a revised version in 1981 (the so-called "US Model").[6] These were withdrawn in 1992 as part of a review of treaty policy.[7] A new US Model was issued on 20 September 1996, together with a Technical Explanation.[8]

Another Model was published by the United Nations in 1980. This treaty is the result of more than ten years of preparation by a group of experts appointed by the United Nations Economic and Social Council (ECOSOC). Its structure corresponds to the OECD Model Convention; however, it explores ways of facilitating the conclusion of double taxation conventions between developed and developing countries.[9] The 1980 UN Model consists, in essence, of the OECD Model with some 27 specific adaptations that take into account the interests of the developing countries. The 1980 UN Model was also accompanied by Commentaries. During the 1990s, the UN carried out work on updating the 1980 UN Model. In May 1999 an amended Model was adopted, subject to certain editorial changes. These revisions were adopted in April 2000.[10] It is noteworthy that in recent years the importance of the UN Model has been waning, with the OECD Model becoming the most important.

---

[5] The Netherlands' Model was published in 1988. The Model may be found, 1988, p. 396. For an analysis of the Model, cf. Van Ruad, "The Netherlands Model Income Tax Treaty", in mt.. 1988,241, and Lyons & Van Waardenburg, "Some Aspects of International Tax Treaty Strategy of the Netherlands", 1988, p. 374.

[6] The US Model of 1981 can be found in Van Rsad (ed), Model Income Tax Treaties, Deventer. 1983.

[7] For an overview of US treaty policy cf. Mogle, United States Treaty Policy, FT. World Tax Report. 1983. p.222.

[8] For the text of the 1996 US Model, cf. Doernberg and Van Raad, The 1996 United States Model Income Tax Convention, The Hague, 1997.

[9] The UN Model has bees published by the UN as Document ST/ESA/102 (UN, New York, 980). For a commentary on the UN Model cf. IFA, UN Draft Model Tax Convention, Deventer, 1979. Cf. also Wijnen and Magenta, "The U.N. Model in Practice", in Bulletin, 1997, p. 574. and Owens, "The Main Differences between the OECD and the United Nations Model Conventions", in Vann (ed), OECD Proceedings: Tax Treaties — Linkeage.s Between OECD Member Countries and Dynamic Non.Member Economies, OECD, Paris, 1996.

[10] In the 2000 UN Model, there are fundamental changes and specifications, such as a new arm's length condition with respect to "independent agents with one principal" in Art. 5(7), an exception to corresponding adjustment in case of fraud in Art. 9(3), and new definitions concerning capital gains on "real estate shares" in Art. 13(4). Moreover, the possibility for source taxation on income from independent personal services in case a certain amount is exceeded, was removed from the UN Model. Cf. van Den Bruggen, "Preliminary Look at the New UN Model Tax Convention", in British Tax Rev., 2002, p. 119

Another Model, shaped according to the special interests of developing countries, was adopted in 1971 by the Member States of the Andean group, an alliance between Bolivia, Chile, Ecuador, Colombia, Peru and Venezuela. The Andean Model was drafted as an alternative to the OECD Model and it emphasises the traditional concerns of Latin American countries, especially the source principle.[11]

[11] The Andean Model is published in Supplement D, 1974, p.309.

# CHAPTER 2
# TAX TREATIES AND CONVENTION: PURPOSE, USE AND STATUS

## 2.1 Purpose of Double Taxation Conventions

The purpose of bilateral tax treaties is typically expressed in their preamble[12] to be "the avoidance of double taxation and the prevention of fiscal evasion.[13] And indeed most substantive provisions of the typical bilateral tax treaty are directed at the achievement of this goal. For example, tax treaties contain tie-breaker rules to make a taxpayer who is otherwise resident in both countries a resident in only one of the countries. They also limit or eliminate the source country tax on certain types of income and require residence countries to provide relief for source country taxes either by way of a foreign tax credit or an exemption for foreign-source income.

In reality a treaty is more correctly described as an instrument which refines and improves existing provisions in domestic legislation which are designated to eliminate international juridical double taxation, i.e. most countries have in their own tax law provisions which are designated to alleviate double taxation and the treaty serves to assist in that process and better integrate it with the corresponding provisions in the treaty partner's law,

Moreover tax treaties do not just indicate international sourcing rules that determine in which Contracting States certain income originates or capital assets are located. These rules must be read

---

[12] The OECD and the UN Models leave the contents of the preamble to be dealt with in accordance with the constitutional procedure of negotiating States.

[13] It must be borne in mind that generally tax treaties are utilised for the avoidance of international juridical double taxation and not against international economic double taxation. The definition of juridical double taxation ntuy be found in the Introduction to the OECD Model Tax Convention on Income and on Capital,I. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.". On the other hand, double taxation is "economic" if more than one person is taxed on the same item; for Instance, in the international context, where one country, for tax purposes, makes a downward adjustment of transfer prices paid by a subsidiary company in its transactions with a non-resident parent company, and the country of residence of the parent does not make a corresponding adjustment for tax purposes to the receipts of that company.

together with other rules establishing under what conditions and in relation to which Contracting State the income or assets concerned may be justifiably taxed. Therefore, tax treaties create an independent device to avoid double taxation, through restriction of Contracting States' tax claims, where there could be an overlapping of these claims. In this way, States waive tax claims, and they bind themselves not to levy taxes, or to tax only to a limited extent, in cases when the treaty gives the taxing right to the other Contracting State either entirely or in part. It could be said that tax treaties in a way establish boundaries on domestic taxation. In contrast, a tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope or alters the type of an existing claim.

Moreover, it must be borne in mind that the extent to which a State levies taxes within the limits posed by a tax treaty, can only be made in accordance with its domestic law: indeed a tax treaty cannot create nor extend the taxing rights of a country. For what it has been said so far, the avoidance of double taxation is achieved by employing a set of common definitions in the treaty, by assigning the right to tax items of income to one State or the other, or partly to both of them, and finally by providing for an exemption or credit mechanism to effectuate the avoidance of double taxation.

The emphasis on the elimination of double taxation should not obscure the fact, that most tax treaties have another equally important operational objective: i.e. the prevention of fiscal evasion[14]. This objective counterbalances the elimination of double taxation. The prevention of fiscal evasion primarily refers to cases where taxpayers fraudulently conceal income in an international setting and rely on the inability of tax administrations to obtain information abroad. Over the last decades, globalization and the diffusion of multinational enterprises dealing on the international market have

[14] For a particularly good analysis of the governmental objectives of the tax treaties, cf. Gravelle, "Tax Treaties: Concepts, Objectives and 'types", 1988, p.522.

contributed to a dramatic spread of international tax avoidance and evasion to the extent that countries have felt the need to overcome the strict rule of territoriality and to cooperate with each other. By far the most important form of cooperation is now represented by the exchange of information between revenue authorities of different countries. The exchange of information article (Article 26 of the OECD Model) in tax treaties is the major device utilised for this scope.[15]

In addition to the two principal operational objectives of tax treaties, there are several ancillary objectives. One ancillary objective is the elimination of discrimination against foreign nationals and non-residents. A non-discrimination article which is based on the OECD Model Convention (i.e. Article 25, see further below) furthermore contain specific provisions relating to non-discriminatory taxation in respect of permanent establishments, to deductibility of certain payments, including royalty and interest payments, and, finally, this article contains a provision safeguarding non-discriminatory treatment of non-resident-controlled enterprises (see below). Moreover, most Contracting States provide a mechanism in their treaties for resolving disputes arising from the interaction of their tax system (the so called "mutual agreement procedure", provided for by Article 25 of the OECD Model).

Another reason for having double taxation conventions is that they provide for the reduction of the withholding tax rates on investment income. In fact, it must be borne in mind that withholding tax on investment income (e.g. interest and dividend) is being imposed at a flat rate on the gross amount of income. Therefore the reduction of withholding tax rates is very important for taxpayers.

[15] It has been suggested that whereas the prevention of tax evasion is an explicit objective of tax treaties which are based on an OECD Model Convention, such explicit Objective does not extend to the prevention of tax avoidance, including the improper use of the treaty. Cf. Van Weeghel, *The Improper Use of Tax Treaties, Deventer, 1998, p. 35.*

Moreover, countries that apply an exemption system as a method for the relief of double taxation will usually apply the tax credit method with respect to investment income.[16]

### 2.2 Relationship of Tax Treaties and Domestic Law

Double taxation conventions are international agreements and their creation and their consequences are determined according to the rules contained in the above-mentioned Vienna Convention on the Law of Treaties. By signing the treaty, the Contracting States commit themselves to initiating the procedures necessary under the domestic law to conclude a treaty, but there is no commitment to conclude it. A treaty cannot be applied until it is concluded or comes into force. It comes into force only after the Contracting States declare their consent or ratify through an exchange of instruments under their respective constitutional laws.[17]

Each State follows its own rules for the some countries follow the monistic principle where the domestic law is linked and subordinated to the international law under the so called "doctrine of incorporation". Other countries follow the dualistic doctrine where the international and domestic law treated separately and require a specific domestic legislation under the "doctrine of transformation". Each State is free to decide its approach under its own laws to comply with its international obligations. Thus, there are two groups of countries:

---

[16] See para. 47 of the OECD Commentaries on Art. 23 of the OECD Model. Note that Art. 23A (Exemption), pars. 2, of the OECD Model, provides for the switch to the tax credit method for the interest and dividends flows of income.

[17] As far as the relationships between tax treaty and domestic law is concerned, see. amplius, OECD, Tax Treaty Override, 1989; Edwards-Ker, Tax Treaty Interpretations, London, Ch. 33; Rezek, — LLithi, Tax Treaties and Domestic Legilsation, 43rd IFA Congree, Rio de Janeiro, 1989; Vogel, On Double Taxation Conventions, Deventer, 1997, p.67.

(i) Direct effect: international treaties are self-executing and automatically become a part of the domestic law when they are ratified.[18] In some countries, the treaty may require parliamentary approval;[19]

(ii) Indirect effect: treaty provisions must be enacted into domestic law and require special legislative steps.[20] The Courts cannot enforce the treaty provisions until they are "transformed" into domestic law, normally by a legislative act or delegated legislation. Under the dualistic doctrine, it is usually the related statute, and not the treaty, which has legal authority under the domestic law.

The provisions of tax treaties are intended to have precedence over any inconsistent provisions of domestic tax law. Again, how this is affected is a matter for the constitutional law of the countries concerned. A common practice is to insert such a provision either into the law giving effect to the treaty or into the domestic tax law itself. The usual result of such a provision under the law of most countries is that, apart from the administrative treaty provisions on the mutual agreement procedure and the exchange of information, a treaty sets limits on the operation of domestic law but does not expand its operation.

Thus, if a country wishes to tax business profits arising from sales to residents of the country by a resident of another country without reference to a permanent establishment in the country, the business profits article of a tax treaty will usually prohibit such taxation, unless those profits are attributable to a permanent establishment in the country. The outcome is the same if the domestic law uses a permanent establishment concept, but the concept is wider than that used in a relevant treaty. Similarly, if the tax applied under domestic law to dividends and interest paid to a resident of

[18] E.g.: France, Japan, Netherlands, USA.
[19] E.g.: Germany, Italy, Ireland.
[20] E.g.: Canada, India, United Kingdom.

the other treaty country exceeds the maximum rates permitted in the treaty, the source State is obliged to reduce its taxation accordingly.

On the other hand, if a country levies no tax on dividends or interest paid to non-residents, then the fact that a treaty allows such taxation up to a specified limit does not mean that such dividends and interest are taxable. It is possible, however, for domestic law to provide that if a treaty permits taxation that does not otherwise occur under domestic law, then the treaty rule will become the domestic rule for this case. This is the position in France[21] (and many Francophone African countries under their tax legislation) where unique provisions in its domestic law enable taxing income attributed to it by a tax treaty even when no tax liability would normally arise under general domestic law.

A convincing lecture of the relationship between the domestic law and tax treaty can be found in the so called "three steps approach" of M. Edwardes-Ker.[22] According to this author, the application of a tax treaty should be divided into three steps: step one must be for the domestic law of the relevant State to be applied to determine if this State's domestic law does, potentially, impose tax. Thus, in step one, domestic law must be applied without regard to tax treaties. If no tax arises under that State, the tax treaty is never applied, since, as already stated, a treaty cannot impose/create tax.

On the other hand, if tax does arise under that State law, then, in step two, the tax treaty is applied to see how it allocates the right to tax the income or the capital in question. If the tax treaty precludes this State from taxing at all, the tax treaty will override this State's domestic law, and this is the end of the matter. However, the treaty could pose a limit up to which the State can tax (e.g. 10% for interest). Step three is to determine a State's actual right to tax within treaty-defined limits.

---

[21] FRA CGI 165 bis, 209 I

[22] Estwarda-Ker, Thx 7)'eaty Interpretations, London, Ch. 33.

Therefore, according to this approach, in step three, domestic law applies except to the extent that its application is precluded by a tax treaty.

## 2.3 Treaty Shopping

Treaty shopping has come under scrutiny in recent years. It is defined as the routing of income arising in one country to a person in another country through an intermediary country to obtain the tax advantage of tax treaties. It usually involves the "flow-through" of income through conduit companies in treaty havens. Other examples include triangular structures where a low or zero taxed branch of a company Ill LI treaty country receives income from a third country. A third example of treaty shopping may involve the use of hybrid entities that are characterised differently in two Contracting States.[23]

Generally the use of tax treaties by third country residents to obtain treaty benefits not available directly to them is lawful, as long as it is not prohibited by treaty provisions or general international law. However, many countries regard treaty shopping as unacceptable and improper. Therefore, several jurisdictions have enacted specific anti-treaty shopping provisions.

The main categories of anti-treaty shopping measures are:

(i) Specific measures that deny benefits to entities, which are not subject to tax in their State of residence. That is the case of Luxembourg 1929 holding companies which are generally excluded from Luxembourg tax treaties;

---

[23] For more detailed studies on this subject see Van Weeghel, The Improper Use of tax Treaties, Deventer. 1998: Ward, "Abuse of Tax Treaties", in *Int.* 1995, p. 178 et seq.; David, Oliver. "Access to tax Treaties", in *Int.*, 1989, p. 330 et seq.

(ii) Comprehensive measures imposed under the domestic legislation or treaties.

Germany has enacted a general provision in the German Tax Code under the Anti-abuse and Technical Amendment Act to curb treaty shopping by third country residents. According to this disposition the tax authorities can now disallow the treaty and EU Directive benefits to entities that are set up as conduit companies, primarily to take advantage of treaty benefits not otherwise available to them. In Switzerland, the 1962 Abuse Decree excludes fiduciary or collecting agents of non-resident principals from treaty benefits.'[24] Many US treaties contain a Limitation on Benefits Article to exclude certain residents from treaty benefits.[25] The new Article 22 on the Limitation on benefits under the 1996 US Model Treaty is substantially more detailed than the 1981 US Model. It includes various restrictive clauses but it also provides objective safe harbour provisions in case of bona jide business activities.[26] Despite the detailed Provisions and explanations, it contains several subjective rulesthat may be difficult to apply.[27]

Since 1987[28] the OECD considered that treaty shopping was undesirable since it frustrated the spirit of the treaty, if not the provisions. The recommendations of the 1987 Report have been included in the Commentaries to Article 1 of the OECD Model Convention. The OECD Model Convention itself expresses concern over treaty shopping but provides only a rudimentary solution to the

---

[24] See Reinarz. "Revised Swiss Anti-Treaty Shopping Rules", in Bullet., Mtr. 1999; Hull, Teuscher, "Treaty Relief in Switzerland on Outbound Investment", in Bullet., Feb. 2001

[25] See Van Herksen, "Limitation on Benefits and the Competent Authority Determination", Jan. 996.

[26] Under the US- Netherlands treaty, the taxpayer must have a business purpose for residing in the Netherlands' and holding their US investments through a Dutch entity. In addition to other objective safe harbours, it provides or additional qualifying provisions to extend derivative treaty benefits to other European Union residents, us well as a headquarters—company test. Furthermore, it includes six subjective or "intent" factors to assist the competent authority in applying the principal purpose test.

[27] As evidetwed by Ellis, "Limitation on Benefits — a Netherlands Perspective", in ml., 1989, 8/9.

[28] See OECD (Committee on Fiscal Affairs). Double Taxation Conventions and the Use of Base and Conduit Companies. Paris, 1987. The 1998 OECD Report [OECD (Committee on Fiscal Affairs), Harmful Tax Competition, 1998, pp. 46.50f refers to treaty shopping and mentions that it encourages harmful tax competition. It, therefore, advocates more extensive use of tax treaties to counter such competition.

problem. It contains few provisions limiting its use. For instance, the treaty benefits are denied if a person is not liable to worldwide tax in his country of residence. Indeed, a treaty shopper must qualify as a resident under Article 4, paragraph 1, of the OECD Model Convention, i.e. he must be liable to comprehensive taxation (full liability to tax on world income) under the domestic law.[29] And again, Articles 10 (dividends), II (interest) and 12 (royalties) mention that only a "beneficial owner" is entitled to treaty benefits. As already analysed, the Model Convention excludes the concessional withholding tax benefit from the legal owner if he is not the beneficial owner and the beneficial owner is not a resident in the same Contracting State. The legal owner cannot benefit as an intermediary with very narrow powers, such as a nominee or agent or a conduit company, unless the beneficial owner is also a resident of that State. The 2003 amendments to the OECD Model Commentaries contain important novelties in the subject, proposing the introduction of new provisions on possible anti-abuse measures, new provisions on possible measures against harmful tax competition and clarifications regarding the requirement of beneficial ownership.[30]

[29] The Commentaries specifically refers to the esclsrsion of conduit companies in treaty havens that tax-exempt oftshore income of resitletits. See OECD, Com,nentaries, C(4)—8.

[30] For a description of these measures see IBFD, OECD Model Tax Convention on Income and on Capital 2003(Condensed version) and Key Features of Tax Systems & Treaties of OECD Member Countries, Amsterdam, 2003; Vegh, "The 2003 OECD Model", in Eur. Tax., 2003, p. 244cr seq.

## CHAPTER 3

## TAX TREATY INTERPRETATION AND JURISPRUDENCE

Fiscal jurisdiction is often the most aggressively guarded jurisdiction of any nation. As a consequence, even in times when economies are going global and borders fading, leading to liquid movement of goods, services and capital, double taxation is still one of the major obstacles to the development of inter-country economic relations. Nations are often forced to negotiate and accommodate the claims of other nations within their heavily guarded fiscal jurisdiction by the means of double taxation avoidance agreements, in order to bring down the barriers to international trade.

### 3.1 The Vienna Convention on the Laws of Treaties

Tax Treaties are international agreements entered into between States. The interpretation of international treaties[31] is governed by public international law, and more specifically by customary international law, as embodied in the Vienna Convention on the Law of Treaties.[32]

---

[31] The literature on tax treaty interpretation is particularly extensive, see, *ex multis*, Avery Jones *et al.*, The interpretation of Tax Treaties with particular reference to Art. 3(2) of the OECD Model, in British Tax Rev., 1984, Nos. I and 2: Vogel, On Double Taxation Convention, Deventer, 1997, p. 33; Vogel, "The Influence of the OIJCD Commentaries on Treaty Interpretation", 2000, p. 612; Ellis, "The Influence of the OECD Commentaries on Treaty Interpretation — Response to Prof. Dr. Klaus Vogel", 2000, p. 611; Avery Jones, The "one true meaning" of a Tax Treaty, 2001, p. 221; Avery Jones, "The Effect of Changes in the OECD Commentaries after a Treaty is Concluded", 2002, p. 102; Lang, "How Significant are the Amendments of the OECD Commentary Adopted after the Conclusion of a Tax Treaty?",Van Raad, "International Coordination of Tax Treaty Interpretation and Application", *in Int.*, 2001, p. 212; Van Raad, "Interpretation and Application of Tax Treaties by Tax Courts". in Eur, Tax., 1996, p.3; Wattel and Manes, "The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties", in Eur. Tax,, 2003, p.223.

[32] The Vienna Convention mien have been referred to in a growing number of decisions around the world involving the interpretation of double taxation conventions. Cf., inter alia, the Australian case Title! e. F.C.T. (1990)90 Australian Tax Cases 4,717 (High Court of Australia); the Canadian case Hunter-Douglas v. R.. (1979)79 Dominion Tax Cases, 5,340 (Federal Court) and the well-known R. v. Crown Forest Industries Ltd. (1995) 95 Dominion Tax Cases 5,389 (Supreme Court of Canada); the U.K. case (.RC. v. Commerbank AG. (1990) Simon's Tax Cases 285 (High Court). For other cases where the Vienna Convention has been cited in

According to Article 31, paragraph 1, of the Vienna Convention, "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose".

Thus, Article 31 of the Vienna Convention is based on the view that the text must be presumed to be the authentic expression of the intentions of the parties, and that, in consequence, the point of interpretation is the elucidation of the meaning of the text (so called "textual approach"), and not an investigation ab initio into the intentions of the parties.

The "ordinary meaning" of the terms is not necessarily that of everyday usage. To the extent that an internationally uniform legal usage or to the extent that a specific technical language — such as tax law — has developed, the "ordinary" usage is within the meaning of Article 31, paragraph 1 of the Vienna Convention.

The "context" under Article 31, paragraph 2, includes the text of the treaty and any agreements between the parties made in connection with the conclusion of the treaty and any instrument made by one of the parties and accepted by the other party. With reference to tax treaties, this includes notes or letters exchanged during the signing of the treaty. However, unilateral explanations by one party that have not been expressly confirmed by the other party cannot be included.[33]

In addition, under Article 31, paragraph 3, subsequent agreements between the parties and subsequent practice with respect to the interpretation of the treaty and any applicable rules of

---

the context of the interpretation of a double taxation convention, cf. Edwards-Ker, Tax Treaty Interpretations, London, Ch. 33, paras 3.03-3.16.

[33] For instance, the US Department of the Treasury usually publish technical explanation in connection with the publication of treaty text. According to Vogel, On Double Taxation Conventions, Deventer, 1997, p.38. these kinds of documentation are neither part of the context of the treaty nor materials, and neither Art. 31, pam. I and 2, nor Art. 32 grant their use in treaty interpretation.

international law must be taken into account together with the context. Moreover, according to Article 31, paragraph 4, a special meaning must be given to a term if it is established that the parties so intended.

It must be borne in mind that the application of paragraphs 1,2 and 3 of Article 31 is a single combined operation, since such article has to be considered as a single, closely integrated rule. Under Article 32 of the Vienna Convention, other material, referred to as supplementary means of interpretation, which include the *travaux préparatoires* (preparatory work) of the treaty, are only to be considered to confirm the meaning established pursuant to Article 31, or to establish the meaning if Article 31 produces an ambiguous, obscure, absurd or unreasonable result.

Article 33 of the Vienna Convention provides that in respect of treaties authenticated in two or more languages, each language is equally binding. According to Article 33, paragraph 4, in the case of discrepancy in the meaning between two (or more) linguistic versions, the interpretation adopted should be the one that best reconciles the different versions.

### 3.2 Reference to the OECD Commentaries

Although the OECD Model Treaty and Commentaries are very important for the interpretation of tax treaties, their legal status under the provision of the Vienna Convention is unclear. However, in current case law on interpretation of double taxation conventions reference has been made and is increasingly made to the OECD Model Convention.[34]

---

[34] Cf., for instance, the recent Philip Morris decision of the Italian Supreme Court (Decision No. 7682 of 25 May 2002, published in Dir. prat. trib. inter., 2002, No. 3), where constant reference to the OECD Commentaries is made by the Court.
Cf. OECD, Commentaries, Introduction, para. 29.3. viz. The courts are increasingly using the Commentaries in reaching their decision; Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member

Scholars disagree on whether the use of the OECD Commentaries is in accordance with the rules set out in the Vienna Convention. Nevertheless, the Commentaries have been viewed either as an "ordinary meaning" in the sense of Article 31 of the Vienna Convention,[35] or a "special meaning" in the sense of Article 31, paragraph 4,[36] or as a supplementary means of interpretation in the sense of Article 32 of the Vienna Convention.[37]

At first glance, they could appear to be supplementary means of interpretation under Article 32. However, if so, they are relevant only to confirm the meaning otherwise established by the application of the principles of interpretation in Article 31 or to establish the meaning if the meaning under Article 31 is ambiguous, obscure, absurd, or unreasonable.

On the other hand, the OECD does not intend for the Commentaries to have such a limited role.[38] In our opinion, as far as the interpretation of tax treaties between OECD countries is concerned, the OECD Model Convention and the Commentaries should be considered as primarily part of the "context" and not simply "preliminary materials" in the sense of Article 32 of the Vienna Convention.[39] The OECD Commentaries will be less significant for treaties between an OECD member and non-member and between two non-member countries. However, insofar as the OECD

---

countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge's deliberations.

[35] Professors Vogel and Prokisch (*General Report*, in Cahiers, vol. LXX VIlla, 1993, 63) believe that the OECD Commentaries fall within the instruments made in connection with the conclusion oft me treaty cx art, 31, pars. 2,lett. b) of the Vienna Convention, since they represent the result of discussions among OECD Member countries, which could make reservations to the Commentaries.

[36] Ault, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", in Alpert and Vait Raad, Essays on International Taxation. To Sidney I. Roberts, 1993, p. 61; Avery Jones, "Tax Treaty Interpretation in the United Kingdom", in Lang (ed), Tax Treaty interpretation. Vienna, 2001, p. 364.

[37] Mössner. "Zur Auslegung von Doppelbesteuerungsabkommen", in Liber Arnicorum I. Seidl.l-iohenveldern, 1988, p. 403; Steichen, "Tax Treaty Interpretation in Luxembourg", in Lang (ed). Tax Treaty Interpretation, Vienna. 2001, p. 234.

[38] Cf. OECD, Commentaries fall within the i,msrrun,cnts made in conneCtio,m ivill, the concl,tsio,m oft/me treaty cx art, 31, pars. 2, lett. b) Introduction, part,. 15,

[39] In the Thiel case [Thiel v. F.C.T (1990)90 Australia,, Tax Cases 4,717], the Australian High Court held that the OECD Model Convention and Commentaries should be regarded as part of tIme context under Arl.3 I of the Vienna Convention.

Model Convention served as a basis for the negotiations of the last mentioned treaties, it should be considered as part of the "context" as well. It is difficult, however, to justify including the Commentaries as part of the context of a treaty under Article 31 of the Vienna Convention, especially if the treaty being interpreted was entered into before the Commentaries were revised or if one of the Contracting States is not a member of the OECD and therefore had no part in the preparation of the Commentaries.

It is even harder to find a justification in the Vienna Convention for applying a later Commentaries version to the interpretation of an existing treaty. The OECD Commentaries, at paragraph 35 of the introduction, address the issue in a very elegant way.[40] In any case, the Commentaries are, after all, a mere aid to the interpretation of the tax treaty text, and subsequent amendments to the Commentaries should not override the text of an existing Convention, especially now that there are more and more frequent versions of the OECD Commentaries (1992, 1994, 1995, 1997, 2000 and 2003).[41]

### 3.3 The Interpretation Rule of Article 3(2) of the OECD Tax Model Convention

In addition to the provisions of the Vienna Convention, tax treaties based on the OECD Model Convention contain an internal rule of interpretation. In fact, Article 3, paragraph 2, of the OECD

---

[40] Cf. OECD, Commentaries fall within the instruments made in connection with the conclusion of the treaty en art, 31, pars. 2, lett. b) Introduction, pars. 35 : "Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles."

[41] Actually, there is a debate among the scholars on the significance that must he attributed to the amendments of the OECD Commentaries after the conclusion of a, tax treaty: see Vogel. "The Influence of the OECD Commentaries on Treaty Interpretation", 2000, p. 612; Ellis, "The Influence of the OECD Commentaries on Treaty Interpretation Response to Prof. Dr. Klaus Vogel", 20(81, p. 6111; Vaim Raad, "Interpretation and Application of Tax Treaties by Tax Courts", ut Ear. 'Tax., 1996. p.4 Avery Jones, "The Effect of Changes in the OECD Commentaries after a Treaty is Concluded",.2002, p. 102; Lang, "How Significant are the Amendments of the OECD Commentary Adopted after the Conclusion of a Tax Treaty?", in Dir. post. trib. inter., 2002, P. 6 and Wattel and Manes, "The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Thx Treaties", in *Eur. Tax.*, 2003, p. 225 .

Model Convention provides that undefined terms used in the treaty have the meaning that they have under the domestic law of the country applying the treaty, unless the context otherwise requires.[42] Article 3, paragraph 2, is considered as being a general provision with respect to the special rules of interpretation of double taxation conventions, and namely the convention definitions such as those found under Article 3, paragraph 1, or under Article 4 (resident), Article 5 (permanent establishment), Article 6, paragraph 2 (immovable property), Article 10, paragraph 3 (dividends), Article II, paragraph 3 (interest) and Article 12, paragraph 2 (royalties). Each of these definitions has priority over the general *revoi clause* contained in Article 3, paragraph 2.[43]

The rule under Article 3, paragraph 2, has several practical advantages: first of all it prevents excessive length in drafting double taxation conventions that would render the application of treaties difficult. Moreover, fiscal authorities, national courts and taxpayers can keep to the meaning of a term that they know from their domestic law.

On the other hand, the rule could often lead to a different application of the treaty in the two Contracting States.

Article 3, paragraph 2, was amended in 1995 to provide that an undefined term should have "the meaning that it has ... under the law of that State for the purposes of the taxes to which the Convention applies, any meaning given to the term under other laws of that State". It clearly states that it is the tax law definition that is to be applied, though this may import a definition from the

---

[42] As far at Art. 3, para. 2, of the OECD Model Convention is concerned, see Avery )ones et at., "The Interpretation of Tax Treaties with particular reference to Art. 3(2) of the OECD Model", in British Tax Review, 1984 p05mm; Vogel, On Double Taxation Convention, Deventer, 1997, p. 42; Baker, Double Taxation Conventions, London, loose-teaf ed., E.t9.

[43] Cf. Vogel, On Double Taxation Convention, Deventer, 1997, p. 209.

general law. Moreover, it is clear that if a term used in the treaty has a meaning in a branch of domestic law other than that of taxes, its meaning under tax law shall prevail.

The article at stake says that the domestic law meaning shall apply "unless the context otherwise requires". This raises the further issue of what constitutes "the context"[44] and what matters may be taken into account before resolving reference to the domestic law meaning.[45] Article 31, paragraph 2, of the Vienna Convention defines the context for the purposes of the treaty interpretation as including any preamble or annex to the treaty, any agreement reached between the parties and any instrument accepted by the parties as relating to the treaty.

Commentators have pointed out how this notion of "context" seems to be too narrow. In fact, the "context" concept should be interpreted as broadly as possible:[46] context should encompass the relevant provisions of the two national legal systems and also the Model Convention and the Commentaries.

Therefore, the departure from interpretation by reference to domestic law will be admissible to the extent that the context, in this broad sense, reveals arguments in favour of such a departure.

Another important and controversial issue of interpretation in connection with Article 3, paragraph 2, of the OECD Model Treaty is whether a term has its meaning under domestic law at the time that the treaty was entered into (the so called static approach) or the meaning at the time the treaty is applied (the so called ambulatory approach). The OECD Commentaries make clear that the

---

[44] The OECD Commentaries (OECD, Commentaries, C (3)-12) states that: "The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore atlows the competent authorities sonic leeway."

[45] This point is widely discussed in Avery Jones et al., 'The Interpretation of Tax Treaties with particular reference to Art, 3(2) of the OECD Model", in *British Tax Rev.*, 1984, p.90.

[46] Cf. Vogel, On Double Taxation Convention, Deventer, 1997, p. 214.

ambulatory approach should, in principle, be applied.[47] In fact, with relevant changes in a Contracting State's domestic tax law, it might be impossible for that State to continue to apply the Convention.

Most countries appear to apply the ambulatory approach,[48] and some have even incorporated it into treaties explicitly. The ambulatory approach allows treaties to accommodate changes in domestic law without the need to renegotiate the treaty. However, although the ambulatory approach seems correct, radical amendments to domestic law should be excluded from Article 3, paragraph 2.

### 3.4 Conflicts of Qualification

The attribution of a certain payment to one of the tax treaty classes of income is particularly difficult where the treaty does not define the term in question. In such cases, the Contracting States often favour a classification based on their own law, regardless of whether or not Article 3, paragraph 2, of the OECD Model is applicable. As a result, the Contracting States will often apply the treaty differently if their classifications under domestic laws differ. For instance, if a severance payment is characterised as deferred compensation, it would appear that Article 15 of the OECD Model Treaty would apply, and the payment could be subject to tax in the country where the services were rendered. If characterised as a pension payment, Article 18 of the OECD Model Treaty provides that it is the country of residence that has exclusive tax jurisdiction.[49]

---

[47] Cf. OECD, Commentaries, C(3)- II, "the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the tatter interpretation should prevail, and in 1995 amended the Model to make this point explicitly".

[48] Cf. Edwards-Ker, Tax Treaty interpretations, London, Ch. 9 and 10.

[49] Another example of double taxation arising from differences in domestic law meanings is the well-knows Boulez case (Decision of the U.S. Tax Court in (1984) 83 Tax Court Reports (U.S.) 584) discussed in Eur. Tax., 1985, p. 154.

It is clear that, resulting from conflicts of qualification in the countries of source and residence, double taxation or double non-taxation may occur.[50] Moreover the interplay of the tax credit method and the exemption method of relief from international double taxation introduce a further dimension of complexity.

There has been a big debate among scholars[51] for many years on whether the residence State, i.e. the State where the taxpayer is a resident, is required to categorise income when giving relief under a tax treaty for the tax paid in the source State. The debate should now have an end after the amendments to the OECD Commentaries made in 2000, following the OECD Partnership Report.[52]

The clarification added to the OECD Commentaries states that the residence State should accept the source State's qualification of the income and give relief accordingly, even if the residence State would have classified the income differently.[53] Thus the residence State has to exempt, or to give credit for the tax in the source State on income "which, in accordance with the provisions of the Convention, may be taxed [in the source State]".[54]

---

[50] See the new approach proposed by the 2000 version of the OECD Commentary.

[51] There is a summary of this debate in Rotondaro, "The Application of Art. 3. para. 2, in case of Differences between domestic definitions of 'Associated Enterprises", in *Internat. Tranafer. pric. Jours.*, 2000. p. 172.

[52] OECD, The Application of the OECD Model Tax Convention to Partnership, Issues", in *Internat. Tax., no.* 6. Paris, 1999,

[53] Cf. C (23)—32. I et seq. in the version of the OECD Model Tax Convention on Income and Capital of Apr. 2000 states: "32.2 The interpretation of the phrase 'is accordance with the provisions of this convention, may be taxed', which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purpose of the provisions of the Convention.
32.3 Different situations need to be considered in that respect. Where, due to differences in the domestic lass between the State of source and the State of residence, the former applies. With respect to, a particular item of income or capital, provisions of the Convention that are different horn those that the, State al residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law".

[54] Arts 23A (1) and 23B(1) of the OECD Model Convention,

Therefore if the source State, applying the treaty and referring to its domestic law *ex* Article 3, paragraph 2, regards a severance payment (back to our previous example) as not falling within Article 18 since in its domestic law the term "pension" does not encompass such remuneration, but as falling under Article 15, then the residence State has to grant an exemption or credit notwithstanding its own qualification. The residence State must refrain from inserting its own categorisation of the income, which leads to all the problems we pointed out before. It must only check whether the source Stale has taxed the income in accordance with the treaty, which merely involves the residence State reading and not applying the treaty.

Part of the doctrine has supported the view[55] that the divergence in interpretation of treaty terms arising from differences in domestic law which both Contracting Slates apply pursuant to the general *renvoi* clause (Article 3, paragraph 2), rather than he solved by the obligation of the residence State to follow the source State's qualification, should be removed through the set up of a lingua franca, a sort of international fiscal language.[56] According to the these writers, such a development would he possible through a comparison of the legal system of the States and by looking at the decisions made so far by the Courts[57] and tax authorities. In creating this international fiscal language a key role would be played by the OECD Committee on Fiscal Affairs, which should establish a specific meaning for every tax treaty term.[58]

---

[55] Vogel-Prokinch, "General Report", is Cahiers, vol. LXX Viliti, I 983, p. 63, and Van Raad, "International Coordination of tax Treaty interpretation, and Application", in Int., 2001, p 215

[56] Another possible solution is for a State to determine unilaterally what a term means for treaty purposes for Instance, in respect of pension and annuties, Canada, in its Income tax Conventions Interpretation, Act (section 5.11, gives its own definition of the terms

[57] Professor Vogel and prokisch (ibidem) report a case of a South, Africa Court (SIR V Downing) where there is an express acknowledgement of the existence of "International fiscal language", a reference of the *Bundesfinanzhof* (BFH BStB I.II) II 1986.

[58] Professor van Raad also endorses a creation of a panel of independent tax treaty experts to which, submit upon the request the Courts and competent authority's opinions on die interpretation of a specific tax treaty clause and its application, to the case under consideration.

# CHAPTER 4

# BASIC CONTENTS OF MODEL TAX TREATY

The tax treaty under the Model Conventions contains the classification and assignments rules (so called distributive rules[59]) for avoiding double taxation. These "distributive rules" classify the various items of income by type and source and then assign the taxing rights to the Contracting States. For each State, they specify the three alternatives by source of income, namely (i) full taxing rights, (ii) limited or shared taxing rights, or (iii) no taxing rights for one of the Contracting States,

Generally, the source country has the taxing rights Limited to the income derived front sources within its territorial jurisdiction. On the other hand, the residence State has full taxing rights on the worldwide income. Therefore, except as provided under the treaty, the residence State retains the rights to tax all income and capital. However, it is required to give relief for double taxation to the taxpayer if the same taxing rights are given to the source State. In the OECD Model Treaty, relief from double taxation is provided either by Article 23A (Exemption Method) or by Article 23B (Credit Method).[60]

## 4.1 Coverage and Scope

Under Article I of the OECD Model, the provisions of the treaty apply to persons who are "residents on one or both of the Contracting States", A "person" is defined in Article 3, paragraph I, to include "an individual, a company and any other body of persons". Any legal entity that is recognised under the laws of a Contracting State is likely to be treated as a "person" for tax treaty purposes. Although a partnership is probably a person for purposes of a typical treaty, it may not be

[59] The distributive rules are contained in Arts 6 to 22 of the OECD Model Convention.

[60] In respect to Art. 23A and Art. 23B of the OECD Model Tax Convention, see Avery Jones etal., "Credit and Exemption under Tax Treaties in cases of differing income characterization", in *Eur. Tax.*, t 996, p. 11 8.

a resident of one of the Contracting States if the partners rather than the partnership are liable to tax there.[61]

Article 4 of the OECD Model defines what is to be understood by "resident of a Contracting State" for the purposes of the Convention,[62] It refers to criteria, such as "domicile, residence, place of management or any other criterion of a similar nature", which, under the domestic law of one or both of the Contracting States, establish (lie worldwide tax liability of a person. Residence of a person in one or both of the Contracting States generates such person's treaty entitlement, namely the authority to claim rights under the double taxation convention. Article 4, paragraph 2, contains the so-called "tie-breaker rule": this paragraph realizes to the case where, under the provisions of paragraph I, an individual is a resident of both Contracting States. It determines the individual's treaty residence by connecting factors, which have to be applied in a specific order.[63] In the event a person, other than an individual (such as a company), is a resident of both Contracting States, Article 4, paragraph 3, determines the treaty residence to be the State in where the "place of effective management" is located. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. This ll ordinarily be the place where the most senior person or group of persons (e.g. board of directors) makes its decisions. No definitive rule can however be given and all relevant

---

[61] As far as the application of the Convention to partnerships, cf. OECD, Commentaries, C(l ).2 er seq. OECD, The Application of the OECD Model Thx Convention to Partnership, cit. In literature, see Schaffner, "The OECD Report on the Application ofTax Treaties to Partnerships", 2000, p.2l 8 et seq.; Doernberg. van Ratid, "Hybrid Entities and the U.S. Model Income Tax Treaty" .

[62] For the notion of residence for treaty purposes, see Ward et al, "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries", tn Canad. Tax Journ., 1996, p. 408 et scq.; Vogel, On Double Taxation Conventions, Deventer, 1997, p. 229.

[63] The allocation of treaty residence to one country is achieved through a hierarchy of tests involving the individual's permanent's home, centre of personal and economic relations, habitual abode, and nationality. Cf. OECD, Conimentaries, C(4)-9 .

facts and circumstances should be examined.[64] Article 2 (taxes covered) of the OECD Model specifies the taxes that are covered

by the treaty. It provides that the treaty is to apply "to taxes on income and on capital in) posed on behalf of a Contracting State or of its political subdivisions or local authorities", e.g. provincial taxes, municipal or communal taxes. Article 2, paragraph 3, extends the treaty to the new taxes introduced after the treaty has been signed, provided they are identical or substantially similar to the existing taxes to which the treaty applies. The competent authorities in the Contracting States must notify each other of any significant changes in their taxation laws.

### 4.2 Income from Immovable Property

Article 6 (income from immovable property) of the OECD Model gives the right to tax he income derived by a resident of a Contracting State from immovable property or real property situated in the other Contracting State to that State. The right is not exclusive. Although both Contracting States may tax the income from immovable or real property, the State of source or *situs* of the asset or right has the primary taxing right. The article does not apply to income from immovable property located in the State of residence or in a third State; the provisions of Article 21 apply to such income.[65] Under Article 6, paragraph 2, the definition of the term "immovable property" is based on the domestic law of the State, where the property is situated. Immovable property expressly includes "property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights under domestic law attached to landed property, usufruct of immovable property,

---

[64]Cf OECD, Commentaries, C(4)-2 I et seq. See alto Romano, "The Evolving Concept of 'Place of Effective Management' as a Tie Breaker Rule under the OECD Model Convention and Italian Law", in Eur. Tax., 2001, p. 339.
For a discussion on the triangular cases arising in presence of dual resident companies, cf. Van Raad, "Dutl Residence", in *Eur. Tax.*, p. 241 et seq. and Avery Jones and Bobbett, "Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London", in Bullet., 1999, p. 19.
[65] Cf. OECD, *Commentaries*, C(6)-l.

and rights to variable or fixed royalty payments for the working of, or the right to work, mineral deposits, sources and other natural resources". The situs principle under this article takes precedence over the rules, contained in Article 7 of the OECD Model, governing the business profits (see further Article 6, paragraph 4).

### 4.3 Business Income

The taxation of business income is governed by Articles 5 and 7 of the OECD Model Convention. In particular, Article 7 provides the rule regulating the taxation of business profits, and since the 2000 revision of OECD Model, it also regulates income from professional services and other activities of an independent character, previously dealt with under Article 14.[66]

According to Article 7, paragraph 1, the profits of an enterprise[67] carried on by a resident of a Contracting State shall be taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If an enterprise of a Contracting State has a permanent establishment in the other Contracting State, then it is taxable in the source State only on the taxable income attributable to the permanent establishment.

The definition of the term "**permanent establishment**" is provided in Article 5 of the OECD Model Convention.[68] The permanent establishment concept (hereinafter also "PE") is a threshold

---

[66] The OECD Commentaries [C (7) -2.11 makes now clear that 'The elimination of Article 14 on 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax calculated according to which of Article 7 or 14 applied...".

[67] For an analysis of the notion of the term "enterprise" in the context of the Model Convention, see van Raad, "The Term 'Enterprise' in the Model Double Taxation Conventions — Seventy Years of Confusion", in *int.*, 1994, p. 491.

[68] Vogel, On Double Taxation Conventions, Deventer, 1997, p. 271-356; Skaar, Per,nanent Establish,nent, Deventer, 1991; Ifs, 'The Development in Different Countries of the Concept of a Permanent Establishment", in Cahiers, vol. 52, Deventer, 1987; Baldwin, "Fixed, Business and Permanent

for source State taxation of business profits; it is a criterion reflecting the involvement of a non-resident person in the economy of the source State to a significant degree.

The first paragraph contains the general definition of "physical PE". The second paragraph contains non-exhaustive list of facilities that may prima facie constitute a PE (such as a place of management, a branch, an office, a factory, etc.). The third paragraph specifies the concept of PE in relation to building sites or construction or installation projects. The fourth paragraph contains a list of places of business that, by way of exception, do not constitute PE.[69] The fifth and sixth paragraphs define the concept of "agency PE" and the seventh paragraph contains a rule on associated enterprises.[70]

The definition of a "physical PB" is made up of a number of elements, namely it must be a "fixed place of business through which the business of an enterprise is wholly or partly carried on":

(1) "fixed": both geographically (to a distinct place in the Source State), and in time, i.e. permanently;

(2) "place": there must be a physical space, premises, machinery or equipment; this must be at the disposal of the non-resident (including owned, leased, or shared premises);

---

Establishments", The Tax Journal, Apr. 1997, p. 13-16; Avery Jones and Ward, "Agents as Permanent Establishments under the OECD Model Tax Convention", in Eur. Tax., 1993, p. 154.

[69] The fourth paragraph enumerates preparatory or auxiliary activities, such as (a) the use of facilities solely for the purpose of storage (e.g. warehouse), display (e.g. showroom), or delivery, of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for purpose of storage, display or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise and (e) the maintenance of a fixed place of business solely for any combination of any of the activities mentioned provided that the overall activity is still of a preparatory or auxiliary character.

[70] According to Art. 5, pars. 7, the control of a company, or control by a company does not of itself constitute a PE for the other company, Therefore a subsidiary owned or controlled by its parent does not of itself create a FE for the parent in the source State. The "anti-single entity" clause respects the separate legal identity of a subsidiary.

(3) "of business": it is necessary to carry on a commercial activity, not necessarily "productive" (i.e. profitable);

(4) "Through which business of an enterprise": it is not necessarily "in", so long as the place makes possible the carrying on of business in the source Stale; the PE should be the tool through which the business of an enterprise is carried on;

(5) "Carried on": it is now clear that human intervention is not required, and automation is sufficient.

The PE exists as soon as business itself starts; it ceases when all activities end or ate abandoned, or when the PB business is alienated to a third party.[71]

Article 5, paragraph 3, specifies a special type of PE which does not have to fulfill the requirements of the first paragraph: the so-called "Project PB". It consists of a building site, or construction or installation project — including the construction of roads, bridges, canals, the laying of pipelines, excavating, dredging, and demolishing

— only if it lasts more than 12 months. The minimum period is calculated separately for each site and the aggregation is possible only for those sites forming a coherent geographical and commercial whole,[72]

Where no physical or project PE subsists, a non-resident can still have a PB through an agent, pursuant to Article 5, paragraph 5 (Agency PB). This is because, through its agent, the non-resident is nonetheless involved to a significant extent in the economy of the Source State. According to the last-mentioned paragraph, where a person is acting on behalf of a person and has, and habitually

[71] M These elements can easily be inferred from the Commentaries to Art. 5, psra. I.
[72] Cf. OECD. Commentaries, C(S)- 16 ci seq.

exercises, an authority in a country to' conclude contracts in the name of the person, that person shall be deemed to have a permanent establishment in that country in respect to any activities which that other person undertakes for the person.

The agent's authorisation is a question of fact, and not of a formal grant of agency status. Again, whether the agent binds the principal is a question of fact, and finding an agency PE is not precluded by the fact that the contract was signed by the principal, if the negotiations leading to that contract were determined by the agent.[73]

Whether or not the agent acts "in the name of", depends on whether the authority is granted by a common or civil law jurisdiction. What is required is an authority to bind the principal: in civil law countries this necessitates direct representation, not indirect representation with an undisclosed principal who is not bound. On the other hand, in common law countries, a principal is still bound even if he is not named/disclosed by the agent.[74]

The fifth paragraph does not apply — and no agency PE subsists — to an independent agent acting in the ordinary course of business (see further Article 5, paragraph 6 of the OECD Model).

Thus, if an enterprise has a permanent establishment, as defined in Article 5 of the Model Convention, in the other Contracting State, that State (i.e. the State where the PE is situated) may tax the income attributable to that PE.[75] Hence, the source State cannot tax business profits of a non-resident arising within its territory, unless such profits can be attributed to a PE of the non-resident.

---

[73] Cf. OECD, Commentaries, C(5)-32.

[74] amplius, Avery Jones and Ward, "Agents as Permanent Establishments under the OECD Model Tax Convention", in Eur. Tax., 1993, p. 160; Roberts, "The Agency Element of Permanent Establishment. The OECD Commentaries from the Civil Law View", in In!., 1993. p.402 and Pleijsier, "The Agency Permanent Establishment: the Current Definition", in *Int.*, 2001

[75] Cf. Art. 7, para. 1,of the Model Convention.

The second paragraph of Article 7 requires the use of the arm's length principle to determine the attributable business profits: i.e. the PE's income must be computed as "the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent enterprise". It is equivalent to the profits that a PE might be expected to earn as an independent entity. However, the PB's taxable profits must be computed after the deduction of all expenses, which are incurred for the purposes of the PE, such as a share of executive and general administration expenses.[76]

### 4.4 **Dividends, Interest and Royalties**

As already stated, a major objective of most tax treaties is to provide for reduced rates of withholding tax levied by the source State on dividends, interest and royalties paid 'to residents of the other Contracting State. This objective is being addressed in Articles 10 (dividends), II (interest) and 12 (royalties) of the Model Convention. And indeed, the amount of tax imposed by the State of source is restricted, while the recipient's State of residence gives credit for the levied by the State of source, and does so even where the treaty otherwise employs the exemption method (see further Article 23A, paragraph 2, of the OECD Model).

[76] Cf. OECD, Commentaries, C(9)-16 et seq. As far as the allocation of income and expenses to the PB is concerned, see Van Raad, "Deemed Expenses of a Permanent Establishment under article 7 of the OECD Msxtet", in mt., 2000, p. 253 et seq.; Becker, "The Determination of Income of a Permanent Establishment or Branch", in In!.. 1989, p.73 en seq.

The Model specifically defines the term dividends (Article 10, paragraph 3) interest (Article 11, paragraph 3) and royalties (Article 12, paragraph 2), so as to make the definitions contained in the domestic law of the Contracting States uniform.[77]

Article 10, paragraph 1, stipulates dividends taxation by the State where the shareholder resides. Moreover, the second paragraph of Article 10 authorises source State taxation of the dividends albeit only at a limited rate, The Model provides for different maximum tax rates, depending on whether intercompany dividends (direct investments) or dividends from portfolio investments are involved. As per portfolio dividends, the maximum rate applicable is 15% of the gross amount, whereas it is of 5% in the case of intercompany dividends when the parent holds at least 25% of the capital of the distributing company.

Article 11, paragraph 1, authorises unlimited taxation by the residence State of the recipient. However, the State of source may tax the interest, but only at a limited rate: the maximum rate applicable amounts to 10% of the gross income (Article 11, paragraph 2).

Contrary to Articles 10 and 11, which provides for a tax sharing between the two Contracting States, Article 12 (royalties) assigns exclusive tax rights to the residence State of the investor. The reasoning that lies behind this policy choice is to enable the residence State to recapture the revenue foregone by allowing deductions for the expenses incurred by resident taxpayers for the development of the right in respect of which royalties are being paid.

---

[77] Whereas the definitions of "interest" and "royalties" do not rely on domestic definition, the definition of "dividends" does, This can lead to the consequence that one country regards a payment as a dividend whereas another country regards it as something else: for instance, one country may treat a payment on the liquidation of a company to its shareholders, in whole or in part, as a dividend, whereat another country may treat it as a disposal of the shares, and so cover it by the capital gain article in the treaty. See Helminen, The Dividend concept in International Tax Law, The Hague, 1999, p,81 en seq.

Articles 10, 11 and 12 stipulate that the treaty benefits — i.e. the reduction of the withholding taxes for dividends and interest and tax exemption for royalties in the State of source — shall be available only if the beneficial owner of such payment is resident

in the other Contracting State.[78] The term beneficial owner, which is not defined in the Model Convention,[79] is not to be construed by reference to domestic laws of the State applying the treaty. The term is instead to derive its meaning with reference, to the context of the treaty, with a view to the purpose pursued by the restriction. In particular, the clause is aimed at denying treaty benefits whenever an intermediary (such as an agent or a nominee) is interposed between the beneficial owner and the company paying out the dividends merely to enable the beneficial owner to get access to treaty protection whenever the beneficial owner is not entitled to it, since he is not a resident of the other Contracting State.[80]

The distributive rules on dividends, interest and royalties generally take precedence over the provisions of business profits contained in Article 7. However, Article 10, , paragraph 4, Article 11,

---

[78] For the notion of beneficial owner in the context of Model Convention, see Oliver-Libin-Van Weeghel-Du Toit, "Beneficial Ownership", in Bullet, 2000, p. 310 et seq.; Du Toit, Beneficial Ownership of Royalties in Bilateral Tax Treaties, Amsterdam, 1999; Van Weeghel, The Improper Use of Tax Treaties, London-The Hague-Boston, 1998, p. 54-91; Vogel, On Double Taxation Conventions, Deventer, 1997, p. 561-564; Born, "Beneficial Ownership—Decision of the Netherlands Supreme Court of 6 Apr. 1994, n. 28638", in Ear. Tax., 1994, p. 469 et seq.; Ward, "Abuse of Tax Treaties", in Albert and Van Raad (edt.), Essays on International Taxation, London-The Hague-Boston, 1993 (Series on International Taxation, no. 15) and Killius, "The Concept of "Beneficial Owner" of Items of Income under German Tax Treaties", in *Int.*, 1989, p. 340 et seq.

[79] Only few tax treaties support the term. For example, under the Germany-Italy treaty a person is a beneficial owner if he owns the asset and the rights over them, and the related income is attributed to him. The US Model Convention 1996 regard a person as a beneficial owner if the income is attributable to him for tax purposes as a resident. However, the domestic law may still exclude a person if he receives the income but in substance does not have the control or the rights over it.

[80] See OECD, Commentaries, cit., C(10)-12.1, where it is stated: "Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State.

paragraph 4 and Article 12, paragraph 3, provide an exception for cases where the holdings, debt claims and usable assets, are effectively connected to a permanent establishment maintained by the enterprise in the State of source. In this case, the source State encounters no restriction for what concerns the level of the rate of tax applied to these items of income. For instance, the source State is allowed to tax interest income earned by a bank through a PE at the tax rates generally applicable to business income, not at the special rate generally applicable to interest income.

The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises ass consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object atid purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled 'Double Taxation Conventions and the Use of Conduit Companies' concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties."

### 4.5 Employment and Pension Income

Article 15 governs the taxing rights on income from employment and it is a *lex generalis* in relation to the other Articles on employment income, i.e. Article 16 (director's fee), Article 17 (artistes and sportsmen), Article 18 (pensions) and Article 19 (government service), which take precedence as

leges specilaes. Thus, whenever an item of income should fall outside the provisions of the aforementioned articles, Article 15 will display its umbrella function.[81]

Under Article 15, the State of residence has the exclusive right to tax the salaries,

wages and other similar remuneration derived by a resident of that Contracting State, unless the employment is exercised in the other Contracting State (see further Article 15, paragraph 1), In the latter case, the State of activity may taxes the remuneration derived by the activity performed in its territory, only if one of these conditions is met:

(i) The physical stay of the employee in the State of activity exceeds 183 days in any 12-month period that begins or ends in the tax year concerned[82]

(ii) The remuneration is paid by, or on behalf of, an employer who is a resident in the State of activity[83] or

(iii) the remuneration is borne by a PE that the employer has in the State of activity.[84]

---

[81] For a dissertation of the umbrella function of Art. 15 vis-à -via Arts 16, 17, 18 and 19, see Potgens, the 'Closed System' of the Provisions on Income from employment in the OECD Model", in *Eur. Tax.*, 2(8)1.

[82] In reference to the calculation of the 183-day period, see OECD, The 183 day rule: some problems of applicctiion and interpretation, in OECD Model Tax Convention: four related studies, Issues in international taxation, n. 4. It is now clear that reference must be made to the days of physical presence (ef. OECD, Commentaries, cit., C(15)-5J, therefore the following days are included in the calculation: part of a day, day of arrival l the work State, day of departure from the work State. all days spent in the State of activity such as Saturdays, Sundays and other holidays, day of sickness, etc.

[83] For an analysis of the expression "paid by, or on behalf of, an employer", see Do 13roe, Ct ul,, "Interpretation of Article 15(2)(b) of the OECD Model Convention: 'remuneration paid by, or on behalf of, teit employer who is not a resident of the other State", in Bullet., 2000, p.503 et seq.

[84] The third condition has been clarified by the addition provided to the OECD Commentaries in 20(X) IC( I 5)-7 I; "The phrase 'borne by' must be interpreted in the light of the underlying purpose of subparagraph c) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that a deductible, having regard to the principles of Article 7, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually deducted the remuneration in computing the

The reasoning behind conditions (ii) and (iii) is to guarantee the source taxation of

employment income to the extent that such income is allowed as a deductible expense in the activity State, either because the employer is taxable as a resident there, or because he maintains a PE in the State of work, to which the remuneration of the employee is attributed.

Article 16 provides that directors' fees and other similar payment derived by a resident of a Contracting State (whether an individual or a legal person), in the capacity of a member of board of directors of a company which is a resident of the other Contracting State, may be taxed in that other State. This only applies to payments received by members of the board of directors only in such capacity (thus excluding other income earned from the same company). The Model contains no special provision for the situation where the company has a permanent establishment in the other Contracting State to which a director is assigned and for which his work is primarily carried out. It has been suggested[85] that in this case the directors' fees should be taxable in the State of the permanent establishment.

Income derived by artistes and sportsmen is governed by Article 17: according to this article income may be taxed in the State where their personal activities are exercised. Therefore, the primary taxing rights are given to the State of performance (source) and the justification is that the State of residence can very likely be a tax haven or may otherwise have difficulties in keeping track of the artistes and sportsmen because of their high mobility.[86] No specific rules for the State of residence

---

profits attributable to the permanent establishment is not necessarily conclusive since the proper teSt S whether the remuneration would be allowed as a deduction for tax purposes; that test would be net, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled". Thus, as a consequence of what stated in the Commentaries, the accounting proceeds are not relevant for this purposes.

[85] Baker, Double Taxation Conventions and International Tax Law, 2nd edn, London, 1994, p. 314.

[86] See, amptiux, OECD, "Taxation of Entertainers, Artistes and Sportsmen", in Issues in internat, *Taxat.*, No. 2, 1987; Sandler, The Taxation of International Entertainers and Athletes. All the Worlds stage, The Hague,

are indicated in Article 17, though the Commentaries suggest subject-to-tax clauses and tax credit method also to exemption countries, so as to avoid double non-taxation.[87]

The second paragraph of Article 17 is primarily aimed at a particular form of tax avoidance where a performer contracts with another person that this other person will have the right to provide the performer's services. As long as that other person does not have a permanent establishment in the country where the services are performed, the profits received by the other person in consideration for supplying the services would be not subject to taxation in the State where the services were performed under Article 7 Model Convention. The paragraph at stake counters this by providing that income in respect of personal activities exercised by an entertainer and sportsman which accrues to another person may be taxed where the activities are exercised.[88]

Pensions and other similar remuneration are taxable, under Article 18, only in the State of residence of the recipient. Thus the place where the employment was effectively exercised and the residence of the payer are insignificant. In fact, the provision does not establish any link between the right to tax and the type of work in connection with which the pension was built up.[89]

---

1995; Grams, "Artist Taxation: Art, 17 of the OECD Model Treaty — a Relic 0f Primeval Tax times?, in *Int.* 1995, p. 193 et seq. See Molenaar, 'Obstacles for International Performing Artists", in Eur.,Tax., 2002, p. 149 and Nitikman, "Article I? of the OECD Model Treaty — An Anachronism?", in In?., 2001, p. 268 et seq. for analysis of the "side-effects" of provisions contained in Art. 17 of the Model Convention.

[87] Cf. OECD, Commentaries, C(17)-12.

[88] See Molenaar and Grams,"Rent-A.Star —The Purpose of Art. 17(2) of the OECD Model", in Bullet., 2002, p. 500 tind l3et ten and Lonibardi, "Article 17(2) of the OECD Model in Triangular Situations — Does Article 17(2) Apply if the Artiste or Sportsman is Resident in a Third State?", in Bullet., 1997, p. 560 et seq.

[89] It is uncertain whether severance payment and lump-sum compensation upon termination of employment fall under An. 18, the altvmatives being Arts 15 and 21. However payments compensating loss of office houl d not fall under Art. 18 insofar as they replace income that could have been earned by the employee. Moreover severance pay designed to ease the burden on an employee moving to another job or paid on premature dismissal and designed to bridge a waiting period should come under Art. 15, because it was based on the previous employment relationship. See Ballancin, "Art. 18 of the OECD Model Tax Convention", in Dir., prat., trib., intern. ,2002, p. 128.

Article 18 overrides the general rule contained in Article 15 for remuneration in respect of dependant personal services, and it has to be read in conjunction with Article 19, paragraph 2, dealing with income from government services including pensions. If a pension is paid for work performed as employee of a State or political subdivisions or local authority thereof, the taxing right is assigned to the country paying the pensions only, unless the recipient is not only a resident but also a national of the country of

residence. Article 18 consequently does not apply to pensions paid in consideration of past employment with the State authorities of a Contracting State. On the other hand, Article 18 will be applicable to private pensions paid in consideration' of a past employment, including cases where the Contracting States themselves carry on a business and employ people in this respect.[90]

With certain exceptions, individuals performing services on behalf of a Contracting State are taxable only by that State, pursuant to Article 19, paragraph I, of Model Convention. Students and certain business apprentices or trainees who visit a Contracting State for educational or training purposes are generally not taxable in that Contracting State on the foreign payments they receive for maintenance, education, or training under Article 20 of the Model Convention. Some tax treaties also provide reciprocal exemptions for visiting professors and teachers.

### 4.6 Capital Gains and the "Other Income" Article

Article 13, paragraph I, makes it clear that gains from the disposition of immovable property are also taxable in the source country (*situs* principle). According to the Commentaries, the gains arising from the alienation of immovable property situated in the Contracting State in which the alienator is a

[90] Art. 19, pars. 3. Cf. OECD Commentaries, C(18)-l: "It also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19".

resident in the meaning of Article 4 of the Model Convention, or in a third State, shall be covered by Article 21, paragraph 1[91]

Several countries specifically provide in their tax treaties that the right to tax gains from the disposition of shares of a company is reserved to the source country when the assets of the company consist primarily of immovable property. It is noteworthy that in the 2003 version of the OECD Model, it has been added a paragraph to Article 13, where it is provided that "gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State". The provision brings an exception to the general rule of taxation of gains deriving from shares (taxation in the State of residence of the alienator), to counteract all those avoidance-aiming manoeuvres that exploit Article 13, paragraph 4, to avoid the taxation in the State of *situs* as set forth by Article 13, paragraph 1.

The gains from the alienation of movable property forming part of the business property of a permanent establishment may be taxed in the Contracting State where the permanent establishment is situated, even if the property is located in the other Contracting State. It must be borne in mind that, in such case, the movable property must be attributable to the permanent establishment (cf. Article 13, paragraph 2).

Gains from the alienation of any property other than those referred in the first three paragraphs of Article 13, are taxable only in the alienator's State of residence, as provided for by paragraph 4 of the

[91] Cf. OECD Commentaries, C(t3)-22,

mentioned article. Article 13, paragraph 4, is a catch all clause, and encompasses gains from the alienation of shares in a company or of securities, bond debentures and the like.[92]

Finally, Article 21 of the Model Convention gives exclusive taxing rights to the State of residence, if the income of a resident of a Contracting State, wherever arising, is not dealt with under the distributive rules contained in Articles 6 to 22.[93] The article also covers sources of income that are not covered in the specific articles. In fact, most distributive rules (e.g. Articles 6, 10, 11, 12 etc.) deal with taxing rights over income that has a source in one Contracting State and is paid to a resident of the other Contracting State. This article covers income with source in one Contracting State when paid to a resident of the same State and income sourced in a third State that is paid to a resident of one of the two Contracting State.

An exception is contained in the second paragraph of Article 21 when the income nor dealt with is received by a resident of a Contracting State from an activity, which is effectively connected with its

---

[92] It should be noted that, in special circumstances the gains deriving by the sale of shares may not fall under Art, 13, pars. 4 of the Model Convention, Cf. OECD Commentaries, cit., C( I 3)-3 I: "If shares are sold by shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated prolits and not as a capital gain, The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10, ... The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article II".

As far as the characterisation of income from the purchase of shares by the issuing company, see Betten, "Tax Treaty Interpregjon; Income from the Purchase of Shares by the. Issuing Company: Dividend and Capital Gain?", in Eur. Tax., 1993, p.424 and Huiskes, "Capital Gains on a Company's Repurchase of Shares", is Eur, Tax., 1994, p.472.

As for the application of tax treaties to emigration taxes, see, amplius, Betten, income Tax Aspects of Emigration and immigration of individuals, Amsterdam, 1998, p. 112 et seq.

[93] E.g. winnings from gambling, financial derivatives, punitive damages, etc. See Ward et al., "The Other Income Article of Income Tax Treaties", in Bullet,, 1990, p. 409 et seq.

permanent establishment on the other Contracting State. The taxing rights are then given to the State where the permanent establishment is located (hence Article 7 applies). This exception does not apply to income from immovable property as the State of *situs* always has the primary right to tax)[94]

## 4.7 Non-Discrimination

The non-discrimination article (Article 24) of tax treaties is designated to ensure that foreign investors in a country are not discriminated against by the tax system compared with domestic investors.[95]

The first paragraph of Article 24 lays down the non-discrimination principle based on nationality. It follows that only a national of either of the two Contracting States irrespective of the State of which he is resident may invoke the non-discrimination provision. In particular, it prevents nationals of one Contracting State from being subjected to any taxation (or any requirements connected therewith) that is other or more burdensome than that imposed on nationals of the other Contracting State in the same circumstances, in particular with respect to residence. Therefore a non-resident alien is not in the same circumstances as a resident national: the provision does not prohibit discrimination against non-residents, but only discrimination on grounds of nationality alone. Because most countries do not tax individuals on the basis of nationality, this provision is primarily important with respect to legal entities.

---

[94] Rust. "Sass Principle v. Permanent Establishment Principle in International Tan l.aw", in Bulk's., 2002, p. 15 el seq.

[95] " Sec the comprehensive work of Van Raad, Non-Discrimination in international Tax Law, The I laguc, 1986, passim; Amatucci (F). II principio di non discriminazionefiscale. Padova, 1998.

It must be borne in mind that Article 24 applies to taxation of person and not to income; thus the discrimination in taxing foreign income compared to domestic income is not covered: e.g. if a taxpayer has a choice between straight-line depreciation and declining balance method in determining income from domestic business activities, a taxpayer with foreign business income cannot rely on Article 24 in computing his foreign profits for purposes of double taxation relief, to have the same choice.[96]

Article 24, paragraph 3, provides that permanent establishments of enterprises of one Contracting State should be subject tb no less favourable taxation than the laxatiolt of enterprises of the other State carrying on the same activities. The OECD Commentaries

discuss at length six aspects of equal treatment of permanent establishment, viz, the assessment of tax, the special treatment of dividends received in respect to holdings owned by permanent establishments, the structure and rate of tax, the withholding tax on dividends, interest and royalties received by a permanent establishment, the credit for foreign taxes and the extension to permanent establishments of the benefit of double taxation conventions concluded with third State.[97]

Considering the last-mentioned aspect, it is noteworthy that Article 24, paragraph 3 does not imply that the permanent establishment located in a Contracting State of an enterprise resident of the other Contracting State may take advantage of the first. mentioned State's treaty with a third State. In the case that the permanent establishment "receives" dividends, interest or royalties that are effectively connected to that PE from a third State, the Commentaries recommend (paragraphs 5 1-52), to the extent that double taxation of the permanent establishment's profits cannot be avoided

---

[96] Cf. Avery Jones ct at., The Non-Discrimination Article in Tax Treaties", in British Tax Review, 1991/I, p. 359.

[97] Cf. OECD, Commentaries, C(24)-24 ci seq.

by the unilateral tax credit relief of the domestic law of the PE State, the inclusion of a provision in the treaty between the PE State and the resident State of the enterprise, that obligates the PH State to credit the tax paid by the permanent establishment in the third State. However, the maximum credit should be the level of tax provided for in the tax treaty between the resident State of the enterprise and the third State.

Article 24, paragraph 4, provides that, subject to the position where a special relationship exists between the enterprise and the recipient pursuant to Article 9, paragraph 1, Article 11, paragraph 6 and Article 12, paragraph 4, interest, royalties and other disbursements paid to a resident of the other Contracting State must be deductible to the same extent that they would be deductible if paid to a resident of the same State. This provision does not prohibit the thin capitalisation rules in force in the Contracting States, as long as they are compatible with Article 9, paragraph I and Article II, paragraph 6.[98] However, the Commentaries[99] add that if thin capitalishtion rules apply only in respect to non-residents creditors, excluding resident creditors, then such treatment is prohibited by paragraph 4.

Article 24, paragraph 5, ensures that corporations, partnerships and other entities resident in a country, whose capital is owned or controlled by residents of the treaty partner, must be treated no less favourably than domestically owned or controlled enterprises. The Commentaries clarify that this provision is aimed at prohibiting discriminatory taxation on enterprises, not on the persons owning or controlling their capital. Therefore the provision does not extend to shareholders of the other Contracting State: namely Article 24, paragraph 5, does not prevent income stemming from

---

[98] "Sec OFCD, "Thin Capitalization, Taxation of Entertainers, Artistes and Sportsmen — Issues", in Internet. Taxat., No, 2, Paris, 1987. As for the relationship between thin capitalisation rues and tax treaties, see F.C. Dc Hosson and Michielse, "Treaty Aspects of the 'Thin Capitalization' Issue — A Review of the OECD Report",1989. P. 476 ci seq.; Luthi, "Thin Capitalization of companies in International Tax Law", in Iii,., 991, p. 446 ci seq.; ICC — Commission on Taxation (working Party on Thin Capitalization),

[99] Cf OECD, Commentaries, C(24)-56. Cf. 11,11., C(24).57.

such shareholdings and accruing to non-resident shareholders to be taxed differently from the income accruing to shareholders who are resident of the same State of the enterprise.

It must be borne in mind that the non-discrimination article does not prevent a country from discriminating in favour of non-residents, as with tax holidays or other incentives that apply only to foreign investors nor does the article prohibit provisions in the domestic law that favour the location of investment in the country.

### 4.8 Mutual Agreement Procedure, Exchange of Information and Assistance in the Collection of Taxes

The OECD Model Convention provides a mutual agreement procedure (Article 25) for resolving disputes that arise under a tax treaty. In particular, this article performs three

functions: it provides a dispute resolution mechanism in relation to the application of the provisions of tax treaties to specific cases; it allows the countries to settle common interpretations and applications of their tax treaty; and it allows them to resolve cases of double taxation not otherwise dealt with.

The taxpayer has three years to invoke the procedure from the first notification of the act complained of. The States are obliged under the article to consult on the problem raised by the taxpayer if the State with which the problem is raised is unable or unwilling to resolve it unilaterally, but they are not obliged to resolve the case. However, any agreement reached by them can be carried out despite any time limits Under the domestic law of the Contracting State.

Generally, the mutual agreements are binding on the on the tax authorities to the extent that the treaty, the domestic law or judicial decisions permit them. However, they do not bind the Courts

and, therefore, the taxpayers.[100] Under the Vienna Convention on the Law of Treaties, they must be considered as subsequent agreements or practice when interpreting the treaty (Article 3l,.paragraph 3).

Taxpayer dissatisfaction with the mutual agreement procedure has led some countries to adopt arbitration procedures in their tax treaties for cases where it is not possible for the competent authorities to resolve disputes. The main purpose of such provisions is to put pressure on the tax administration to resolve international disputes rather than to actually engage in arbitrations.[101] As already mentioned, Article 26 of the OECD Model provides for an exchange of information between tax authorities of the Contracting States.[102] Before 2000, Article 26 of the OECD Model was worded so as to restrict exchange of information only to taxes covered by the Convention (i.e. taxes on income and capital) although exchange of information could always take place when necessary to carry out both the provision of the Convention and the domestic laws of the Contracting States. The 2000 version of the OECD Model Tax Convention expressly provides that "the exchange of information is not restricted by Art. 1 and Art. 2", hence allowing countries to

---

100 Vogel, On Double Taxation Conventions, Deventer, 1997. footnote 105.

101 For a discussion of these issues, see Tillinghast, "Issues Arising in the Implementation of the Arbitration of Disputes Arising Under Income Thx Treaties", in Bullet., 2002, p. 90; ibid., "The Choice of Issues to be Submitted to Arbitration under Income Tax Conventions", in Essays on international Taxation, 1993, p. 349 ci seq.; Van Der Bruggen, "The Compulsory Jurisdiction of the ICJ in Tax Cases", in intertax, 2001, p. 250 ci seq.; Bricker, "Arbitration Procedures in Thx Treaties", in Intern. Tax Rev., 1998, p. 97 ci seq. and Zueger, "ICC Proposes Arbitration in International Tax Matters", in Bullet., 200!, p. 221 ci seq.
The EU has implemented an arbitration procedure in transfer pricing eases, Convention of 23 July 1990, on the Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises, 90/436/EEC,O.J.No. C304 of 21 Dec. 1976, 4.

102 In reference to Art. 26 of the OECD Model ef. inter alia. Vogel. On Double Taxation Conventions, Deventer, 1997. p. 402; Ruchelman and Shapiro. "Exchange of Information", in lot.,, 2002, p. 408; Vegh, "Towards a Better Exchange of Information", in Eur., Tax., 2002, p. 394; Oberson, "TIse OECD Model Agreement ott Exchange of Information — a Shift to the Applicant State", in Bullet., 2003. p. 14. The EC Directive (the Mutual Assistance Directive) of 19 Dec. 1977 (77/799/EEC) was originally applied only to direct taxes (of whatever description), but was later extended also to VAT by the EC Directive of 27 Dec. 1979 (79/1070/EEC) and to excise duties by the EC Directive of 25 Feb. 1992 (92/12/EEC).

exchange information concerning any kind of taxes, not also covered by the Convention. This revision is very considerable, although one has to bear in mind that most tax treaties still contain the limitation to exchange information concerning taxes on income and capital only.[103]

The OECD Commentaries on Article 26 have also been modified in 2000: a new paragraph has also been added (paragraph 9.1) where it is stated that the three methods of exchange (on request, automatic and spontaneous[104]) may also be combined. The new paragraph stresses the fact that the article does not restrict the possibilities of exchanging information to these methods and that the Contracting State may use other techniques to obtain information which may be relevant to both Contracting States such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.

Information obtained by the tax department of a Contracting State under an exchange of information article must keep confidential, although release of the information in court proceedings is allowed. Moreover, a Contracting State is not obliged under the exchange of information article to carry out administrative procedures on behalf of its treaty partner that are contrary to its own laws or practices, or that would result in the disclosure of trade secrets or similar information.

Until 2002, the OECD Model Convention was silent on the question of mutual assistance in the collection of taxes.[105] In the 2003 version of the OECD Model, a new Article 27 on Assistance in

---

[103] On the other hand, the Council of Europe/OECD Multilateral Convention on Mutual Administrative Assistaace in Tax Matters has been very broad in scope from the beginising regarding all kinds of taxes, present and future.

[104] From a general point of view, it is possible to say that an isternational exclsaisge of information can be carried out in different forms, namely: (I) upon request; (2) automatically; (3) spontaneously; (4) simultaneous examination. Cf. Vogel, On Double Taxation Conventions, Deventer, 1997, p. 1407.

[105] It is noteworthy, however, that the OECD Committee on Fiscal Affaire prepared a "Model Convent so for Administrative Assistance in the Recovery of Tax Claims" (OECD, Paris, 1981). Moreover in 1988 the

the Collection of Taxes has been implemented. The new article is aimed at ensuring mutual assistance in the collection of revenue claims. As it stands, it provides for comprehensive collection assistance, but the Contracting States may agree on a more limited form of assistance. In particular, the new article specifies two forms of assistance: (i) assistance in enforcing collection (Article 27, paragraph 3) and (ii) assistance in taking measures of conservancy (Article 27, paragraph 4). In any case, when negotiating a treaty, each Contracting State needs to decide for itself whether and to what extent assistance should be given to the other State.[106]

---

OECD and Council of Europe opened for signature a Convention on Mutual Administrative Assistance is Tax Matters (at present, ratified by S countries: Denmark, Finland, Iceland. the Netherlands, Norway. Poland, Sweden, United States). This multilateral convention contains provisions on exchange of information assistance in the recovery of tax, and the service for documents for taxation purposes. It entered into force on 1 Apr. 1995.

[106] Cf. OECD, Commentaries, C(27)-1 and 2.

# CHAPTER 5

## INDO- MAURITIUS DTAA: SAGA OF USE AND MISUSE

### 5.1 Facts and figures in regard of Indo- Mauritius DTAA

India and Mauritius signed a Double Tax Avoidance Agreement on 24-08-1982. Formally titled the 'Convention between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes of Income and Capital Gains', the Convention came into force on 06-12-1983[107]. Under this Convention, taxing rights were allocated between the two countries and also various reliefs for the tax payers hit by the tax systems of both the countries were provided (in the form of 'double tax reliefs'). In the case of the treaty negotiated between India and Mauritius, it seems that what started out in 1983 to be a leg-up for Indian businesses wanting to suply their trade in other countries in the region, turned soon thereafter into an ideal (and much larger) vehicle for entrepreneurs from outside India to avoid double taxation upon their investments made into that country. It is arguably due to the genesis of this treaty that it was then, and remains to this day the most advantageous of all of the DTA's with India. Mauritius has been a classic example of treaty shopping. As the country does not levy capital gains tax, shell companies are formed there to take advantage of this concession. Attempts to pierce the corporate veil in such cases have not met with much success. The Supreme Court has left it for the Central Government to decide what is good for the country in such cases.[108] Treaty shopping has become the order of the day. Income-tax law has provided that in case of conflict, the treaty provision will prevail over the tax law. This has aggravated matters. There is,

[107] vide Notification F. No. 501/20/73-FTD
[108] http://www.lowtax.net/lowtax/html/jmuoltr.html

therefore, an urgent need for a complete reorientation of the Double Taxation Avoidance structure. There are signs of a change in outlook in the recent treaties signed by the Government[109]

### 5.2 Indo- Mauritius DTAA and FDI in India

Over the last two decades, as a result of liberalised fiscal and investment policies, India has stood witness to record GDP growth rates, flourishing services and manufacturing sectors, an exponential rise in foreign direct investment. As a consequence, Mauritius has secured a prominent slot in the tax treaty planning of private equity players, MNCs and global funds. Even in the times of crisis, India is targeting a growth rate of 5 to 6%.

That is not to say that there have been no challenges and changes along the way. In 2003 the Indian Government withdrew the ability of Non Resident Indians to hold their personal portfolios of Indian quoted investments through private Mauritius Companies. The 2004 Indian budget withdrew withholding tax on dividends paid and abolished capital gains tax on certain transactions. But as we shall see, substantial opportunities still exist. So, who has been investing in India in recent years? The following table shows the volume and sources of funds of Foreign Direct Investment ("FDI") for the entire period April 2000 to May 2009.

[109] http://www.maurinet.com/busoff1.html

**SHARE OF TOP INVESTING COUNTRIES - FDI INFLOWS (US$ Millions)**[110]

| Rank | Country | Total 2000 to 2009 | *% of Total of all Countries* |
|---|---|---|---|
| 1. | Mauritius | 39,379 | *44* |
| 2. | Singapore | 8,071 | *9* |
| 3. | U.S.A | 6,508 | *7* |
| 4. | U.K | 5,289 | *6* |
| 5. | Netherlands | 3,701 | *4* |
| 5. | Cyprus | 2,579 | *3* |
| 6. | Germany | 2,379 | *3* |
| 7. | France | 1,233 | *1* |
| 8 | UAE | 995 | *1* |
| | | | |

Mauritius tops the list with a 44% during the period lasting April 2000 to April 2009 (in contrast, Singapore stands at 9% and the U.S. at 7%). With a difference of 35 percentage points between the top two spots and Mauritius not being an investing country in its own right, it is anybody's guess that Mauritius has been used as a holding company jurisdiction for making investments in India with actual investors being tax residents of countries outside Mauritius. The reasons for using Mauritius are simple: India has a tax treaty with Mauritius providing that gains on any transfer of shares in an Indian company by the Mauritius holding company shall not be taxable in India but in Mauritius as

[110] John Harper, Mauritius: The Mauritius/India Double Tax Treaty (Without Tears), http://www.mondaq.com/article.asp?articleid=55688

per the domestic tax laws in Mauritius. Domestic tax laws in Mauritius do not tax capital gains. Therefore, any transaction on account of the transfer of shares in an Indian company by a Mauritius holding company is a tax free transaction both in India and Mauritius.

Round-tripping via Mauritius involves the use of the 1983 Double Tax Avoidance Agreement (DTAA), a tax holiday advantage provided by Mauritius and other tax havens, to re-route money transferred illegally out of India.[111] The illicit funds are then transferred back to India as legitimate foreign investment in the Mumbai stock market via participatory notes.[112] These **'P-Notes'** are used by overseas investors not registered with Indian regulators, allowing them to acquire shares anonymously, which triggers allegations of widespread money laundering. Much of the money invested through **P-Notes** is legal and comes from sources like hedge funds, which seek to benefit from the non-taxation of capital gains on Indian stocks bought in Mauritius, problem of Indian worry is that good money cannot be separated from the bad.[3]

A bigger concern is also about Indian entities using the Mauritius route to launder their unaccounted wealth and manipulate stocks in India. Indian tax authorities find it tough to establish an audit trail of these transactions in the absence of proper exchange of information.

---

111 Swapna Sandesh Sinha , Comparative Analysis of FDI in China and India: Can Laggards Learn from Leaders?, Universal-Publishers, Delhi, 2008, p 26

112 Roderick Millar,Doing Business with India,GMB Publication ltd, Delhi, 2006 p 42

## 5.3 DTAA and Income Tax Act

### Indian Tax Regime

The Income Tax Act, 1961 (ITA)[113] governs taxation of income in India. According to section 5 of the ITA, Indian residents are taxable on their worldwide income, and nonresidents are taxed only on income that has its source in India.Section 6 of the ITA defines who may be a tax resident and contains different residency criteria for companies, firms, and individuals. The scope of section 5 is expanded by the "legal fiction contained in section 9," which deems certain kinds of income to be of Indian source. Indian Policy With Respect To Double Taxation Avoidance Agreements The policy adopted by the Indian government in regard to double taxation treaties may be worded as follows: Trading with India should be relieved of Indian taxes considerably so as to promote its economic and industrial development. There should be co-ordination of Indian taxation with foreign tax legislation for Indian as well as foreign companies trading with India The agreements are intended to permit the Indian authorities to co-operate with the foreign tax administration. Tax treaties are a good compromise between taxation at source and taxation in the country of residence India primarily follows the UN model convention and one therefore finds the tax-sparing and credit methods for elimination of double taxation in most Indian treaties as well as more source-based taxation in respect of the articles on 'royalties' and 'other income' than in the OECD model convention.

---

[113] The ITA favors source-based taxation as compared to the OECD model conventions or treaties entered into by many developed countries that favor residence based taxation. Indian courts have supported source based taxation in several cases in the past.

**Conflict**

The first and the basic issue which arises in the interpretation of a Double Taxation Avoidance Agreement is what is the position where there is a conflict between the provisions of the statute (the Income-tax Act — hereinafter referred to as the Act) and the provisions of the applicable Double Taxation Avoidance Agreement. It is to be remembered that an assessee cannot be worse off by virtue of any provision in the treaty — as the purpose of a treaty is to confer a benefit and not to

levy a charge.

Section 90(2) of the Act makes it clear that where an agreement for granting relief of tax or for avoidance of double taxation has been entered into, then, in relation to the assessee to whom such agreement applies, the provisions of the Act to the extent that they are more beneficial as compared to the provisions of the Double Taxation Avoidance Agreement would have to be applied. It follows that where the provisions of the applicable Agreement are more favourable, compared to the provisions in the Act, the provisions of the Agreement will prevail. Section 90(2) is a statutory recognition of the rule laid down by the Andhra Pradesh High Court in CIT vs. Visakhapatnam Port Trust[114] which view has now been accepted by the Supreme Court in Union of India vs. Azadi Bachao Andolan [115]. Indeed the Central Board of Direct Taxes itself had earlier accepted this position one circular[116]. The Finance (No. 2) Act, 1991, which inserted sub-section (2) in section 90 with retrospective effect from 1-4-1972, also inserted clause (iii) in section 2(37A) to provide that where tax is deductible at source from payments made to a non-resident the payer could apply the rate as prescribed in the Act or the Finance Act or the rate applicable under the relevant Agreement whichever was lower.

---

[114] 144 ITR 146

[115] 263 ITR 706

[116] Circular No. 333 dt. April 2, 1982 reproduced in 137 ITR 1 (st.).

A further refinement, which the blunter would call hair splitting by a bald person, is whether an assessee can claim that the computation of his income should be under say, the Act but the rate of tax should be as per the treaty. According to the writer this is not permissible because a lower rate is often prescribed where, as per the applicable provisions of the Treaty, expenditure is not allowed in computing the particular type of income.

**Choice of Assessee**

The general principle as enunciated above raises several issues. Whilst it is true that the Agreement would override the Act, would it be open to an assessee depending on the provisions in force in different assessment years and the prevailing factual position in each year to opt for being governed by the Act in one year and the applicable Agreement in the other? The view of the writer is that such option is available. The more intricate problem is whether an assessee can choose for the same assessment year to be governed by the provisions of the Act in so far as assessment of a particular type of income is concerned, say, business income, but by the provisions of the Agreement in so far as another type of income is concerned, say, capital gain. In my view this would be permissible as one would, in the language of section 90(2), apply the Act to the extent that the provisions thereof are more beneficial to the assessee. The next issue is whether in respect of the same type of income derived by the assessee from two different states can he opt for being governed by the provisions of the Agreement in so far as state A is concerned but by the provisions of the Act in so far as state B is concerned. For example, an Indian company may have branches (permanent establishments) in state A and state B. The branch in state A makes a profit and the Indian company elects to be governed by the Agreement and takes the stand that the profit is assessable only in country s where there is a permanent establishment, in line with the view taken by the High Courts and the Supreme

Court as referred to hereinafter. The permanent establishment in country B makes a loss and the Indian company desires to set off such business loss against its Indian business income as permissible under section 70 of the Act and does not want to be governed by the provisions of the treaty whereunder the income (which term would include loss) is assessable, as noted above, only in state B. Though the matter cannot be said to be free from all doubt, in the writer's opinion it would be permissible to choose the more beneficial provision "Treatywise."

A further refinement, which the more blunt would call hair splitting by a bald person, is whether an assessee can claim that the computation of his income should be under say, the Act but the rate of tax should be as per the treaty. According to the writer this is not permissible because a lower rate is often prescribed where, as per the applicable provisions of the Treaty, expenditure is not allowed in computing the particular type of income. One cannot therefore take advantage of computation under, say, the Act where it allows deduction of expenditure and then turn to the treaty to apply the lower rate.

As noted above section 90(2) places a Double Taxation Avoidance Agreement at a level higher than the provisions of the Act in that an assessee governed by a treaty can opt for being governed by the provisions of the treaty rather than the Act. As observed by the Supreme Court in **Chettiar's** case[117] referred to hereafter), section 90 and the Agreements executed pursuant to the power conferred there under were provisos or exceptions to the charge of tax levied by sections 4 and 5. In other words, the Agreements become part of the Indian law.

[117] 267 ITR 654

The issue which arises is whether Parliament can enact legislation subsequent to the signing of a treaty which would override the provisions of a treaty and if so whether such legislation has to be in any particular form. Depending on the provision in a country's Constitution as to the status of domestic law vis-a-vis provisions in a treaty the conclusion may be different whether a post treaty domestic law can override a provision in an earlier treaty. The French and Dutch Constitutions do not, it appears, permit the overriding of a treaty provision by a subsequent legislation. The position is different in the United States of America and in the United Kingdom . Though Article 51 of our Constitution provides as a directive principle that the state shall endeavour to foster respect for international law and treaty obligations in the dealings of organised peoples with one another the position appears to be that there is no fetter on the power of the Indian Parliament to legislate in a manner which may conflict with or override the provisions of an earlier treaty just as Parliament can over turn or amend an earlier enacted law. An example of such treaty override is provided by the insertion of the Explanation to section 90 of the Act (by the Finance Act, 2001) and subsequently amending the Explanation by the Finance Act (No. 2) Act, 2004.

To understand the context in which the Explanation was added a few facts may be noted. Some Double Taxation Avoidance Agreements provide that tax on a permanent establishment of an enterprise of one of the states in the other state shall not be less favourably levied in such other state than the taxation levied on enterprises of that other state carrying on the same activities. In India a higher rate of tax is charged on non-domestic companies compared to domestic companies similarly engaged, with the result that the permanent establishment of an enterprise of a contracting state suffers tax at a higher rate. In some cases it was judicially held that such discrimination was not permissible. The Explanation to section 90 now declares that "the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company." In other

words, the Explanation has ruled that rate discrimination is not to be regarded as a less favourable charge of tax obviously for the purposes of Agreements for Avoidance of Double Taxation as only in the case of persons governed by such Agreement would the issue of less favourable rate of tax arise. In so far as tax matters are concerned it has not yet been tested in India whether Parliament can override a provision in an earlier concluded treaty. It is, of course, debatable as to who can have the matter tested as the treaty is between two states. Is it the state which must take up the issue or should it be decided under the mutual agreement procedure or can the affected person challenge the amendment even if the concerned state has not protested? The writer is of the view, which he must confess is not the generally accepted one, that as Double Taxation Avoidance Agreements are agreements between two contracting parties it is not proper for one of the contracting parties unilaterally to change the provisions of the bilateral Agreement. A state cannot, unlike Alice in Wonderland say that words will have the meaning which it chooses to confer on them! It may be noted that by the Finance Act, 2003 sub-section (3) has been incorporated in section 90 which entitles the Central Government by notification to provide that any term in the Agreement which is not defined therein or in the Act shall have the meaning given thereto in the notification so long as such meaning is not inconsistent with the provisions of the Act or the Agreement.

I now consider the position where there is a conflict in the definition of certain terms in the Act and a Double Taxation Avoidance Agreement. The definition of a term (say royalty) plays an important role in appropriately classifying an item of income. Typically Article 3(1) of the Agreements concluded by India contains general definitions. In addition, certain terms are defined in the applicable article. For example, the terms dividends, interest and royalties, normally dealt with, respectively in Articles 10, 11 and 12 of an Agreement, define these terms for the purposes of those articles. There can be no dispute that if there is a conflict between a definition in the Act as existing

when a Treaty comes into force and a definition in the Treaty the latter will prevail. The issues which arise are 1) if there is a definition in the Act at the time the treaty comes into force but there is no definition of that term in the treaty will the definition in the Act apply and 2) if there is no definition of the term in the treaty or in the Act when the treaty was concluded but subsequently a definition is introduced in the Act would that definition be applied also for the purposes of interpreting the treaty?

In so far as 1) above is concerned, the position seems to be clear that in the absence of a definition in the treaty the definition in the Act as existing at the time the treaty is made will be applicable unless the context requires otherwise. The position is not completely clear as to what is to happen where a definition is inserted in the Act or an existing definition in the Act is changed subsequent to the coming into force of the Treaty. Article 3(2) of the OECD Model Convention provides "As regards the application of the Convention at any time by a contracting state, any term not defined therein shall, unless the context otherwise requires, have meaning that it has at that time under the law of that state for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that state prevailing over a meaning given to that term under other laws of that state." It is, therefore, made clear that the definition "at any time" in the local tax law would have to be applied in the absence of a definition in the Convention. If, therefore, a term is defined in the Convention a subsequent change of meaning in the local law will not be applicable but where the term is not defined, then, the meaning under the local tax law as in existence from time to time will have to be applied. This is made clear by the use of the phrases "at any time" and "at that time." These words are absent in the UN and US Model Conventions. Also, in most of the Treaties entered into by India , the relevant provision does not refer to "at any time" or "at that time." Nevertheless the general view appears to be that ..a subsequent definition in the local tax law will have to be applied in interpreting that term in the Agreement. To the writer this appears strange because an

Agreement may have been negotiated on the basis of the meaning of the term as commonly understood. As per the generally held view a unilateral change in the definition may impact on the scope and interpretation of the Agreement. It may also be noted that the OECD Model Convention requires one to have regard to the definition of a term in the Agreement in any local law but preference is to be given to the meaning, if any, under the local tax law. However, as per the US and UN Models as well as the Agreements generally entered into by India it is only the meaning in the local tax law (and not any other local law) which has to be taken into account. The general view mentioned above may lead to the anomalous situation that the two countries may change the meaning of the term under their local laws subsequent to the execution of the Agreement and, therefore, a particular term may be interpreted differently by the Courts of the two states resulting in such income being classified differently by the two states, say, royalty income by one state and only a business income by the other. There is a view that when there is a possibility of such a conflict the definition of the source state would be applicable. In **Siemens A.G. vs. ITO** [118] the Special Bench of the Tribunal accepted the static and not the ambulatory rule and, accordingly, did not interpret the term "royalty" in the then existing ( 1959) Indo-German Double Taxation Agreement on the basis of the meaning given to the term from 1976 in section 9 of the Act. Consider whether the definition in the local law which one has to have regard to as per article 3(2) referred to above is a reference to the "general" definition in the local tax law or a definition restricted to particular provisions. For example, the definition of royalty in section 9 of the Act is for the purposes of certain sections and is not a "general" definition listed in section 2. The issue appears to be a virgin one. The writer is of the view that a definition for particular provisions in the Act would not strictly apply to other provisions in the Act and it would be strange to interpret provisions in a Double Taxation Avoidance Agreement in the light of a definition of limited application in the Act.

---

[118] 1987 22 ITD 87 (SB)

Earlier a reference has been made to a state's power to override a treaty provision. Whether in fact the treaty has been overridden would depend on the interpretation to be placed on the language used in the provision said to override the treaty. The Court would strain every nerve to give full meaning to the treaty unless it is clear that the legislation in question has indeed overridden the treaty provision.[119]

### 5.4 **Provisions of Agreements leading to make Mauritius, a tax haven**

#### A. Capital Gains on transfer of shares

The Indo-Mauritius tax treaty spares foreign institutional investors (FIIs) based in Mauritius from paying capital gains tax on the sale of shares of Indian companies. Treaty shopping should halt. The benefit of the tax treaty should be available only to genuine residents of Mauritius.

The normal rule of taxation of Capital Gains is that the gains arise in the place where capital is transferred. In the case of transfer of shares in a company, the transfer takes place at the registered office of the company. If therefore, the shares of a company are sold the capital gains arises at the registered office of the company. This position is altered to a certain extent by the DTAA between India and Mauritius. The primary benefit under the India-Mauritius tax treaty (the "***Treaty***") is there is no capital gains tax in either India or Mauritius on the sale of the shares of the Indian company by a Mauritius company. Otherwise, the proceeds of a sale of shares in an Indian company are taxed in India even if the seller is not a tax resident of India. The Mauritius approach to investing in India is most applicable when the Indian company is the primary exit vehicle for investor liquidity. This approach can also provide a tax benefit when an acquisition might occur at the Indian subsidiary

[119] Insofar as the issue of treaty override is concerned, a very useful discussion is found in Chapter 33 of Tax Treaty Interpretation" by Michael Edwardes-Ker and also in Double Taxation Conventions and International Tax Law (Second Edition) by Philip Baker (pages 48 - 54)

level rather than at the U.S. parent level. In this case, the U.S. parent company establishes an intermediate Mauritius subsidiary between itself and the India subsidiary.

Article 13 of the Agreement deals with Capital Gains; Article 13(1) refers to immovable property; Article 13(2) refers to business assets (including assets of permanent establishment); Article 13(3) deals with ships and aircrafts; Article 13(4) deals with gains from alienation of property other than those mentioned in Article 13(1) , 13(2), 13(3). Capital gains would therefore be covered by Article 13. According to a recent ruling[120] this Article states that such gains derived by residents of a contracting state shall be taxable only in that State. This means in so far as Capital Gains from sale of shares is concerned, it is the Residence Rule and not the Source Rule which will prevail in accordance with the DTAA. If a resident of a third country with which India has no DTAA were to make an investment in Indian shares and the income of these shares rises sharply and if the shares are sold resulting in capital gains then the capital gain would be taxable in India on the Source Rule basis as gains arise at the registered office of the company whose shares are sold. The investor shall be liable to be taxed on this amount. If on the other hand, the transaction is routed through a Mauritius Offshore Company (ordinary status); the Indo-Mauritius Treaty could be used for "Treaty Shopping". In this case, the investor makes an investment not directly in an Indian Company, but in a Mauritius Offshore Company (ordinary status); the Mauritius Offshore Company the buys the shares of the Indian company. In accordance with Section 2 of the Mauritius Income Tax Act, the residence of the offshore company is in Mauritius as the control is in Mauritius. As no part of the control of the company is in India, the residential status cannot be in India. When the capital gains arises on the sale of shares, although normally, the shares should be taxed in India on the Source Rule basis, Article 13(4) of the Indo-Mauritius DTAA will come into play and this stipulates that taxation of such capital gains should only be on the basis of residence. As the offshore company is a

[120] M/s. E.Trade Mauritius Limited (A.A.R. No. 826 Of 2009 dated 22 March, 2010

resident of Mauritius, it is the Mauritius Government that has the right to tax these profits. As the Mauritius offshore company is one to which the First Schedule of the Income Tax Act applies, although the tax rate is 0%, the company can opt to be taxed on anything from 0% to 35% at its own choice. It would be wise for the Mauritius offshore company to opt for a rate of tax which is lower but not illusionary. If it has opted for 0% rate of taxation although it is a resident of Mauritius, it will go outside the scope of the DTAA because the Double Taxation Agreement will apply only to persons who are residents of either contracting States, but who have income within tax net in both countries. If the DTAA does not apply (for instance a company has opted for 0% taxation), the Indian Income Department will lay claim to tax according to the normal rates of taxation of Capital Gains. The same situation could arise if an illusionary rate of taxation is adopted on the grounds that, an illusionary rate of taxation is merely a sham transaction for the purposes of obtaining benefits of DTAA which would otherwise not be obtained.

**Dividends:**

Article 10(1) of the Indo-Mauritius DTAA stipulates that the dividends paid by a company which is a resident of a contracting State, to a resident of another contracting State, may be taxed in that other State. The normal rate of taxation is, therefore on the basis of residence.

Article 10(2) of the Agreement states that such dividends may also be taxed in the contracting State of which the Company paying the dividends is a resident according to the laws of the State, and, if the recipient is a beneficial owner of the dividend, the tax so charged shall not exceed:

(a) 5% of the gross amount of the dividends if the beneficial owner is a company which holds atleast 10% of the capital of the company directly paying the dividends.

(b) 15% of the gross amount of the dividends in all other cases.

**Business profits:**

Article 7(1) of the Indo-Mauritius DTAA stipulates that business profits of an enterprise of a contracting state shall be taxable in that state, unless, the enterprise carries on the business in the other contracting state through a permanent establishment (PE) situated therein: if there is a business establishment in the other contracting state, then the business profits may be taxed in the other contracting state, but only to the extent attributable to that PE.

A full discussion on what constitutes a PE is beyond the scope of this paper. For the purposes of understanding the illustration on treaty shopping, it is sufficient to know that a PE means a place situated on the Host Country soil of reasonable permanence through which business activities are carried on by the resident of the Home Country in the Host Country. The definition of PE in the model treaties, and the cases adjudicated thereon by foreign courts are wide and it would suffice for the purposes of this illustration, to know that business could to some extent be carried on in the Host Country by a resident of the Home Country without having a PE.

In other words, Article 10(2) enables the host country to withhold tax on dividends on the source rule: the rate of withholding being 5% if the beneficial holder is a company holding 10% of the capital of the company paying dividend, and 15% in other cases.

If therefore a foreign investor company resident in a country with which India does not have a DTAA or a favourable Double Tax Agreement, were to invest directly in an Indian company, when the dividend is paid, in accordance with Section 115 A of ITA, 20% of the dividend would be withheld as tax. If on the other hand he chooses to establish a Mauritius offshore company (ordinary status) and the Mauritius offshore company makes the investment, and the Mauritius offshore

company holds 10% of the capital of the company in which it is investing, tax only to the tune of 5% would be withheld (15% if the condition of the minimum holding is not specified). In Mauritius the offshore company may opt to have a nominal (though not illusionary) rate of taxation. Thus it is seen that as against being taxed at 20% the investor would be taxed only at 7% or 8% (Indian tax and Mauritius tax together). This illustrates treaty shopping by an investor from a country with which India has no Double Tax Agreement or a favourable Double Tax Agreement. [f now, the resident of a country with which India does not have a DTAA or the Agreement is not favourable, wishes to carry on certain business activities in India without having PE and yet earning business profits, on the basis of the Source Rule, India would have the right to tax these business profits, as the profits arise through economic activity on Indian soil. If now, instead of carrying on business directly in India, this person were to establish Mauritius Offshore Company (ordinary status) and this Mauritius Offshore Company were to carry on the business in India without a PE, the Article 7(1) of the Indo-Mauritius DTAA will come into operation. According to this Article, as there is no PE in India, no tax is payable in India even on the basis of Source Rule. When the profits accrue to the Mauritius Offshore Company, the latter will have to opt to pay tax in Mauritius at a nominal rate (not illusionary), so that the Indo Mauritius DTAA could apply in the first place. Thus instead of paying tax at the normal rates applicable to incomes earned from business (which should have been the case had the business investment been done directly) by routing true investments through the Offshore Company, tax would become payable only at a nominal rate, say 2%. This will illustrate treaty shopping in respect of business profits by making use of Article 7(1).

### 5.5 Mauritius Offshore Business Activities Act 1992 (MOBAA)

Under the Mauritius laws, for a company to derive the benefit under the Indo-Mauritius DTC, the Mauritius Offshore Business Activities Act 1992 (MOBAA) comes into play. Under this Act, in

order to gain the benefits of the DTC, certain requirements must be met by the company whereupon it is granted a 'Certificate of Residence' in Mauritius. These conditions are;

•There must be two local (i.e. of Mauritius) directors in the company, who have been approved by the MOBAA authority,

•The company's bank accounts must be in Mauritius, and

•The company is required to comply with the Mauritius corporate law formalities. Once these conditions are met and the Certificate granted, the company is deemed to be a Resident of Mauritius for the purposes of both Mauritius tax law and as well as under the Indian Income Tax Act, 1961.

Onces these conditions are satisfied, the company is granted as 'Certificate of Residence' for Mauritius, and as we saw above, this Certificate is sufficient under the Indian laws to let the income of the person tax free in India. This problem (for India) is particularly enhanced by the fact that Mauritius promotes itself as a off-shore activity business centre. This implies that the country offers significant advantages for companies based in Mauritius but engaged in activities outside Mauritius[121]. Thus the Mauritius government itself advocates for companies from abroad to set their subsidiaries to get incorporated (or otherwise become Resident) in Mauritius and thereupon invest outside Mauritius (typically India because of the tax benefits which come into being) and thus the problem which we have been discussing for long, comes into being.[122]

## 5.6 Legislative Act vs circular under the Act

In the year 2000, in the wake of heightened reports about evasion of tax and treaty shopping, few Income Tax Assessing Officers required the entities operating on India-Mauritius route to prove

[121] http://www.lowtax.net/lowtax/html/jmuoltr.html
[122] http://www.maurinet.com/busoff1.html

that their Residence was established in Mauritius in accordance with the principles for determination of Residence, as provided for under Section 6 of the Income Tax Act, 1961 and as developed and clarified by the courts. This was alleged by the affected entities as an indirect violation of the DTC as there was no such requirement in the DTC. To clarify (and seeming to settle the matter) the Central Board of Direct Taxes (CBDT) issued a Circular[123] clarifying that a certificate of residence issued by Mauritius would constitute sufficient evidence for accepting the status of residence as well as ownership for applying the provisions of the DTC. This implied that the Certificate would override the Income Tax Act, 1961 and therefore was challenged in a public interest litigation. In the same Circular the CBDT had also clarified that the test of Residence would also apply to income from capital gains on sale of shares. Thus, FIIs Resident in Mauritius would not be taxable in India on income from capital gains arising in this country on sale of shares. This exemption from capital gains tax was also challenged as arbitrary, discriminatory and against the spirit of the Act. Satisfied that it was beyond the powers of the CBDT and contrary to the Act, the Delhi High Court declared the Circular invalid and quashed it as inapplicable. *Shiv Kant Jha v. Union of India*, (2002)[124]. However in another public interest litigation *Union of India v. Azadi Bachao Andolan*, (2003)[125], which reached the Supreme Court, a three judge bench headed by Justice Ruma Pal took quiet a contrary view. Stating that in terms of Section 90 and 90A of the Income Tax Act, the Government of India was entitled to make provisions necessary to adopt/implement the DTC with a foreign country and since the CBDT Circular was only clarifying the provisions of the Indo-Mauritius DTC, they were within the legal ambit and thus valid.

---

[123] Circular No. 789 of 2000.
[124] 256 ITR 563
[125] 263 ITR 706

## 5.7 Interpretation of Indo- Mauritius DTAA under Azadi Bachao Andolan case : Tripping of round tripping

One of the first cases where the issue of "treaty shopping" came up for judicial consideration in India was before the Authority for Advance **Ruling**[126] Clause (iii) of the proviso to section 245R ( 2) disables the Authority from pronouncing upon a transaction which is designed prima facie for the avoidance of income-tax, which is, of course, what treaty shopping is all about.[127] Subsequently, the Authority sanctioned the Mauritian route where investors from several countries were to come together and it was necessary to base the investing company in a particular location and Mauritius was chosen as such location even though in making the choice the tax advantage was one of the considerations [128] .

The Supreme Court has exhaustively dealt with this issue in **Union of India vs. Azadi Bachao Andolan**[129]. The Supreme Court appears to have 'blessed' treaty shopping as according to it "If it was intended that a national of a third state should be precluded from the benefits of the DTAC, then a suitable term of limitation to that effect should have been incorporated therein." According to the Supreme Court it was for Parliament to take appropriate action in the matter and in the absence of a prohibition one could not deny the benefits of a treaty on the basis of the belief that treaty shopping was not permissible.[130]

---

[126] No. 9 of 1995 220 ITR 377.

[127] In that case a company in the United Kingdom had invested in India via the Mauritian route. The Authority was of the view that this was to obtain the advantage of non-taxation in India of capital gains arising to a resident of Mauritius under the Indo-Mauritian Double Taxation Avoidance Agreement, which advantage was not available under the Indo-UK Double Taxation Avoidance Agreement.

[128] in Advance Ruling No. 10 of 1996 (224 ITR 473)

[129] 263 ITR 706 at pages 746 - 753

[130] An anti treaty shopping provision is normally inserted in a Double Taxation Avoidance Agreement by a limitation on benefits clause (see, for example article 24 of the Indo-US Double Taxation Avoidance

In the context of India-Mauritius Tax Treaty, the Supreme Court, in the Azadi Bachao Andolan case referred to Article 24 of the Indo-US Tax Treaty[131], which specifically provides the limitations subject to which the benefits under the Treaty can be availed. While pronouncing the judgement in favour of the taxpayer, the apex court observed that in the absence of the limitation clause, such as the one contained in the Indo-US Tax Treaty, there were no disabling or disentitling conditions under the Indo-Mauritius Tax Treaty prohibiting the resident of a third nation from deriving benefits there under.

the Supreme Court of India has upheld the validity of Circular 789 dated April 13 2000 issued by the Central Board of Direct Taxes (CBDT) clarifying that a Certificate of Residence issued by the Mauritian authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for claiming benefits under Indo-Mauritian Double Taxation Avoidance Agreement (DTAA).

Under DTAA, a resident of Mauritius receiving capital gains is not taxable in India. A number of foreign institutional investors (FIIs) have been claiming benefit of this provision in respect of investments made by them in India.

Indian revenue authorities had questioned the eligibility of these FIIs to claim the benefit under DTAA since, in their view, these FIIs were shell companies incorporated in Mauritius, which were controlled and managed from other countries and were basically using Mauritius as a conduit to claim concessional tax rates under DTAA.

---

Agreement which permits a non-individual person to avail of treaty benefits only if more than 50% beneficial interest therein is owned by individual residents of a contracting state.

[131] Efective date under article 30 of Agreement: 1 Jan. 1991

Subsequently, the Indian government issued a circular through CBDT. Two writ petitions by way of public interest litigation were filed with the Delhi High Court challenging the validity of this circular. The High Court quashed this circular, and held that that the conclusiveness of a certificate of residence is neither contemplated under the DTAA nor under the Indian tax law and that 'treaty shopping', by which the resident of a third country takes advantage of the provisions of a treaty is illegal. It was also held that based on the judgment of Supreme Court in McDowell and Co Ltd v CTO,[132] it is open to the income tax officer to lift the corporate veil for ascertaining tax avoidance issues.

The Government of India appealed to the Supreme Court of India to restore the validity of the circular. The Supreme Court set aside the ruling of the High Court and held that the circular is valid. Some of the important observations of the Supreme Court are summarized below.

Further apex court held that under section 90 of the Income Tax Law, the central government is empowered to issue notifications for implementation of terms of tax treaties and such tax treaties would override the provisions of the Income Tax Law as held by various Indian High Courts. Further, based on principle of *stare decisis*, even if the High Court took an erroneous view, it would be worthwhile to let the matter rest, since large number of parties have modulated their legal relationships based on this settled principle of law. A circular within the meaning of section 90 has the legal consequences contemplated by section 90 and it shall prevail even if it is inconsistent with the provisions of the Act. Circular 789 falls within the parameters of the powers exercisable by the CBDT under the Act.

The DTAA held non ultra vires the powers of central government under section 90 merely on account its susceptibility to Treaty shopping by residents of third countries.

---

[132] [1977] 1 SCR 914; 39 STC

The test of validity of a Treaty is to be decided, not by its efficacy, but by the fact that it is within the parameters of the legislative provisions delegating the powers.

The DTAA applies to a resident of Mauritius, which is defined to mean: "any person who under the laws of Mauritius is liable to taxation therein by reason of his domicile, residence, place or management or any other criterion of similar nature". For this purpose, 'liability to taxation' is not the same as payment of tax. 'Liability to taxation' is a legal situation whereas payment of tax is a fiscal fact. What is relevant is the legal situation, namely, 'liable to taxation' and although the Mauritian companies have been granted exemption from income tax in respect of capital gains it cannot be said that these companies are not liable to tax in Mauritius.

It cannot be said that avoidance of double taxation can arise only when tax is actually paid in one of the contracting states. The benefits of a tax treaty would be available even if the other contracting state in which income is to be taxed chooses not to impose tax on such income.

If it is intended that a national of a third country should be precluded from the benefits of the treaty, then a suitable term of limitation to that effect should be incorporated in it. In the absence of a limitation clause, there is no disabling condition under the DTAA prohibiting a resident of a third nation from deriving benefits under it.

If the residents of a third contracting state qualify for a benefit under a Treaty they cannot be denied the benefit on a theoretical ground that Treaty shopping is unethical and illegal.

The principles adopted in interpretation of Treaties are not the same as those adopted in interpretation of statutory legislation. An important principle which needs to be borne in mind while

The apex court, in *Union of India vs Azadi Bachao Andolan*, summarised the legal position with regard to tax avoidance as follows:

Before the Constitution came into being, the principle laid down in the Duke of Westminster case[136] was fully approved and followed in the *Bank of Chettinad Ltd vs CIT* case[137]. This Privy Council judgment was the law when the Constitution came into force.

This legal position continued in terms of Article 372[138] of constitution of India — by which, all the law in force in the territory of India immediately before the commencement of the Constitution

---

136 [1935] All ER 259 (H.L.).

137 *(1940 8 ITR 522 PC)*

138 Article. 372. Continuance in force of existing laws and their adaptation
(1) Notwithstanding the repeal by this Constitution of the enactments referred to in Article 395 but subject to the other provisions of this Constitution, all the laws in force in the territory of India immediately before the commencement of this Constitution, all the laws in force in the territory of India immediately before the commencement of this Constitution shall continue in force therein until altered or repealed or amended by a competent Legislature or other competent authority
(2) For the purpose of bringing the provisions of any law in force in the territory of India into accord with the provisions of this Constitution, the President may by order make such adaptations and modifications of such law, whether by way of repeal or amendment, as may be necessary or expedient, and provide that the law shall, as from such date as may be specified in the order, have effect subject to the adaptations and modifications so made, and any such adaptation or modification shall not be questioned in any court of law
(3) Nothing in clause ( 2 ) shall be deemed
(a) to empower the President to make any adaptation or modification of any law after the expiration of three years from the commencement of this Constitution; or
(b) to prevent any competent Legislature or other competent authority from repealing or amending any law adapted or modified by the President under the said clause Explanation I The expression law in force in this article shall include a law passed or made by a legislature or other competent authority in the territory of India before the commencement of this Constitution and not previously repealed, notwithstanding that it or parts of it may not be then in operation either at all or in particular areas Explanation II Any law passed or made by a legislature or other competent authority in the territory of India which immediately before the commencement of this Constitution had extra territorial effect as well as effect in the territory of India shall, subject to any such adaptations and modifications as aforesaid, continue to have such extra territorial effect Explanation III Nothing in this article shall be construed as continuing any temporary law in force beyond the date fixed for its expiration or the date on which it would have expired if this Constitution had not come into force Explanation IV An Ordinance promulgated by the Governor of a Province under Section 88 of the Government of India Act, 1935 , and in force immediately before the commencement of this Constitution shall, unless withdrawn by the Governor of the corresponding State earlier, cease to operate at the expiration of six weeks from the first meeting after such commencement of the Legislative Assembly of that State functioning under clause ( 1 ) of Article 382, and nothing in this article shall be construed as continuing any such Ordinance in force beyond the said period

shall continue in force until altered or repealed or amended by a competent Legislature or other competent authority.

This principle also acquired the judicial blessings from the Constitution Bench of the Supreme Court of India. The legal principle will continue to hold good unless reversed by a clear verdict of the Supreme Court or by an Act of Parliament. Thus tax avoidance was, is and will be permissible. It is settled law that tax avoidance is always allowed. McDowell was a random decision, which temporarily attempted unsettling this clear legal entitlement. The only ways in which tax avoidance can be threatened are another Supreme Court decision overruling the latest one.

The decision of the Supreme Court (SC), (Union of India v. Azadi Bachao Andolan – 263 ITR 706) (decided on May 31, 2002) appears to be a catalyst for India to take note and insist on the LOB clause in its tax treaties. The SC in this decision upheld the principle that in the absence of a LOB clause, the tax residency certificate, issued by the country of the immediate investor, in this case, the Mauritius resident, cannot be challenged. The SC observed that if it was intended that a national of a third state should be precluded from the benefits of the tax treaty, then a suitable term of limitation to that effect should have been incorporated therein. The tax treaty with Mauritius does not contain a LOB clause.

This does not seem possible in the near-term owing to the extensive research, clinical analysis of series of literature on the subject for the past eight decades in the Azadi Bachao Andolan case.

The other option is that Parliament can legislatively suppress the decision by specifically incorporating anti-tax-avoidance measures.

It can condemn tax avoidance on moral and ideological grounds, but not before looking at the following observations of Justice Sabyasachi Mukharji in the Arvind Narotam case:

"One would wish, as noted by Justice Chinnappa Reddy, that one would get the enthusiasm of Justice Holmes that taxes are the price of civilisation and one would like to pay that price to buy civilisation.

"But the question, which many ordinary taxpayers very often in a country of shortages with ostentation consumption and deprivation for the large masses ask, is does he with taxes buy civilisation or does he facilitate the waste and ostentation of the law."Unless waste and ostentation in government spending are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance."

The courts have attempted to provide some distinction between unacceptable tax evasion and acceptable tax avoidance, which is increasingly referred to as tax planning. However, there certainly exists a grey area between legitimate tax avoidance/planning and illegal tax avoidance and the distinction has become increasingly blurred, in view of varying and often conflicting views of the courts. This leads to increase in uncertainty in the tax system, which is something businesses do not want.

To prevent aggressive tax avoidance, which the Government believes undermines the integrity and equity of the system, General Anti-avoidance Rule (GAAR) has been inserted vide Section 112 of the new Direct Taxes Code (DTC).

**5.9 Summary of Interpretation.**

Principles laid down on treaty shopping and on tax avoidance :

- Court to decide what law is, and apply it; not to make it - *Judicis est jus dicere*

- An Act otherwise valid in law cannot be treated *non-est* based on underlying motive

- In absence of limitation clause, such as one in Indo-U.S. Treaty, resident of a third nation cannot be denied benefits of a Treaty.

- Whether Treaty shopping should continue is discretion of 'Executive'. Court not to judge legality of Treaty Shopping.

- No equity in fiscal statute. Either statute applies *proprio vigour* or it does not. Fiscal statute cannot be applied by intendment

- Madras HC rightly concluded in **M.V. Vallipappan and others v. ITO**[139] that McDowell cannot be read as laying down that every attempt of tax planning is illegitimate.

[139] 170 ITR 238

# CHAPTER 6
## Impact of New proposed tax code on Indo-Mauritius and other DTAAs.

On 12 August 2009, the Finance Minister of India released a new draft Direct Taxes Code Bill, 2009 for public debate.[140] If things move as planned, the Bill is likely to be presented to the Indian Parliament in the Winter Session 2009. Once approved by Parliament and after receiving the President's assent, it will become law and subsequently come into force on 1 April 2011. As discussed further below, the Bill will impact India's existing double taxation avoidance agreements (tax treaties), including, significantly, the Indo-Mauritius tax treaty.

The much awaited Direct Tax Code Bill, 2009 (Tax Code)[141], proposes certain fundamental amendments to the provisions of international tax and transfer pricing in the context of Indian taxation, the notable amongst them being:

**A.** Specific legislation to the effect that the preference of the applicability of a tax treaty or the domestic tax law would depend upon the enactment, which is later in time, as compared to the existing provisions that a taxpayer could choose to be governed by either a tax treaty or the domestic tax laws, depending upon whichever was more favorable to it[142]; and

---

[140] Aug 13, 2009 , New Code promises lower direct tax rates, Business Line

[141] DIRECT TAXES CODE BILL, 2009, available at Ministry of finance, Govt. of India web site,http://finmin.nic.in/dtcode/Direct%20Taxes%20Code%20Bill%202009.pdf

[142] Section 112. (1) Any arrangement entered into by a person may be declared as an impermissible avoidance arrangement and the consequences, under this Code, of the arrangement may be determined by,-
(a) disregarding, combining or re-characterising any step in, or a part or whole of, the impermissible avoidance arrangement;
(b) treating the impermissible avoidance arrangement-
(i) as if it had not been entered into or carried out; or
(ii) in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.
(c) treating parties who are connected persons in relation to each other as one and the same person; or
(d) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

**B.** Introduction of general anti avoidance rules (GAAR), which has been referred to in the explanatory statements of the Tax Code, as to also partake of the nature or character of "treaty override".[143]

GAAR will be invoked if the taxpayer has entered into an arrangement:

(a) The main purpose of which is to obtain a tax benefit, and

(b) Which has been entered into or carried out in a manner not normally employed for bona fide business purposes, or has created rights and obligations that would not be normally created between persons dealing at arm's length, or results in the misuse or abuse of the provisions of the Code or lacks commercial substance.

"Arrangement" has been given a broad enough definition[144] to cover a wide array of transactions, including any interposition of an entity or a transaction where the substance of such entity or transaction differs from the form given to it.[145] A transaction that is conducted through one or more

---

(e) deeming persons who are connected persons in relation to each other to be one and the same person;
(f) re-allocating, amongst the parties to the arrangement,-
(i) any accrual, or receipt, of a capital or revenue nature; or
(ii) any expenditure, deduction, relief or rebate;
(g) re-characterising-
(i) any equity into debt or vice-versa;
(ii) any accrual, or receipt, of a capital or revenue nature; or
(iii) any expenditure, deduction, relief or rebate

[143] The new Direct Taxes Code provides that neither a double taxation avoidance treaty nor the Code shall have a preferential status by reason of it being a treaty or law. Therefore, in the case of a conflict between the provisions of a treaty and the provisions of the Code, the one that is later in point of time shall prevail.

[144] Section 114, clause 1 says:
An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit unless the person obtaining the tax benefit proves that obtaining the tax benefit was not the main purpose of the arrangement.

[145] Any arrangement can be treated as an impermissible avoidance arrangement. In so treating the arrangement, the Revenue can practically do whatever it wants to do. Effectively, the Government can lift the corporate veil as and when it wants to. It can look at the "substance" of the transaction as and when it wants to. The only guideline is provided in the fact that "impermissible avoidance arrangement" is defined in Section 113, clause 14:

persons and disguises the nature, location, source, ownership or control of funds is also an indicator of lack of commercial substance. The designated officer in India's Department of Revenue will be empowered to declare an arrangement as an impermissible avoidance arrangement and, once so declared, the designated officer can then ignore the tax treaty, disregard an intermediary holding company and tax the income in the hands of the parent. An arrangement declared an impermissible avoidance arrangement shall be presumed to have been entered into for the main purpose of obtaining a tax benefit. The onus has been put on the taxpayer to prove that a tax benefit was not the main purpose of the arrangement. The general anti-abuse rule will override the provisions of the tax treaties.

In essence, both the proposed amendments, which are extremely fundamental and go to the roots of the taxation system of India or for that matter, any country, carry elements of "treaty override", albeit in different directions.[146]

**I. Preference between tax treaty and the Tax Code, to the one being later in time**

As mentioned earlier, the provisions of the existing tax laws of India require that a taxpayer can choose to be governed by either a tax treaty or the domestic tax laws, depending upon whichever is

---

impermissible avoidance arrangement means a step in, or a part or whole of, an arrangement, whose main purpose is to obtain a tax benefit and it,-
(a) creates rights, or obligations, which would not normally be created between persons dealing at arm's length;
b) results, directly or indirectly, in the misuse, or abuse, of the provisions of this Code;
(c) lacks commercial substance, in whole or in part; or
(d) is entered into, or carried out, by means, or in a manner, which would not normally be employed for bonafide purposes;

[146] http://www.india-briefing.com/news/law-threaten-mauritius-tax-treaty-2327.html/

more favourable to it. Several foreign countries have entered into tax treaties with the Indian Government against the background of such a scheme of taxation in India. Incidentally, the Indian Government has signed more than seventy comprehensive tax treaties with various countries to date. The Tax Code now proposes that effective on its enactment, which is destined for April, 2011, the preference of the applicability of a tax treaty or the domestic tax code would depend upon which is later in time.[147] A very pertinent question arises, namely, whether the proposed legislation would apply only to tax treaties which would be entered into by the Indian Government after enactment of the Tax Code or would the same also apply to more than seventy comprehensive tax treaties already executed by the Indian Government , i.e., under the aegis of the existing enactment of income taxes, which involve all major countries in the world, since literally, the Tax Code would be the one later in time as compared to all the existing tax treaties? There is no express mention of the intent either in the Tax Code or the explanatory statements of The Tax Code.[148]

In case the former proposition is correct, namely that the proposed legislation would apply only to tax treaties which would be entered into by the Indian Government after enactment of the Tax Code, then probably sovereign nations, seeking to negotiate treaties with the Government of India, and also the concerned taxpayers might not raise eyebrows with respect to the validity of the legislation, since it is the prerogative of the Parliament and the Indian Government to legislate and execute tax treaties in any particular manner.[149] However, in case the latent intention is to apply the proposed legislation to the more than seventy comprehensive tax treaties entered into by the Indian Government to date, i.e., under the aegis of the existing enactment of income taxes, which involve

---

[147] Rahul K Mitra, Anup Seth, Arun Chhabra and Nishant Saini ,New Indian tax code – treaty override and antiavoidance rules available at http://www.pwc.com/en_IN/in/assets/pdfs/DTCtreatyoverrideGAAR.pdf

[148] http://www.deloitte.com/assets/Dcom Global/Local%20Assets/Documents/Tax/Alerts/dtt_tax_alert_india_082109.pdf

[149] Bimal N. Patel, India and international law, Volume 2, Martinus Nijhoff Publishers, p 320.

all major countries in the world, then there could be negative implications, including affecting trade relationships between India and the major countries, and also possible questions being raised about the sanctity of the proposed legislation on the touchstone of arbitrariness, which is the conscience keeper of the Indian Constitution for any Parliamentary or State action.[150] As discussed earlier, there is no express mention of the intent either in the Tax Code or the explanatory statements of the Tax Code of whether the proposed legislation would apply only to the future tax treaties to be entered into by the Indian Government after coming into effect of the Tax Code or even to the existing tax treaties, entered into by the Indian Government under the existing enactment of income taxes.[151] However, it is possible to take a strong argument, based on the interpretation of the Tax Code that the proposed legislation could be said to apply only to future tax treaties to be entered into by the Indian Government after coming into effect of the Tax Code. Section 282(2)(j) of the Tax Code provides that any tax treaty entered into under the aegis of the existing enactment of income taxes, shall be deemed to have been entered into under the Tax Code and continue in force accordingly, provided the same otherwise meets the parameters of negotiation of tax treaties envisaged under the Tax Code, which are more or less similar to those of the existing enactment of income taxes. Now, if an existing tax treaty is deemed to have been entered into under the aegis of the Tax Code, one could strongly argue that the said treaty would have been entered into after the Tax Code comes into force, since unless the Tax Code comes into effect, a tax treaty cannot be entered into by the Indian Government under the powers conferred by such Tax Code. Thus, since the existing tax treaties would be deemed to have been entered into after the Tax Code comes into effect, the provisions of even such existing tax treaties, being later in law as compared to the Tax Code, by virtue of the

---

[150] Dr. S. P. Gupta, Peter T. Knight, Yin-Kann Wen,Intergovernmental fiscal relations and macroeconomic management in large, Economic Development Institute ,Washington, p 20.

[151] Phyllis Lai Lan Mo,Tax avoidance and anti-avoidance measures in major developing economies, greenwood publication, London, p 135.

deeming provision or fiction of law, would automatically prevail over the provisions of the Tax Code and would not stand overridden by the Tax Code. It can also be strongly argued that in any event, the question of overriding of existing tax treaties by the Tax Code on the principle of later in time, would arise only in case of a direct conflict between the provisions of the existing tax treaties and the Tax code through express overriding provisions of tax treaties contained in the Tax Code, and not to general provisions of the existing tax treaties, which are not in express conflict with those of the Tax Code. However, in case the intention is to apply the proposed legislation even to the existing tax treaties by virtue of the fact that the Tax Code would always be the one later in time as compared to the existing tax treaties, notwithstanding the favourable interpretations to the contrary, as discussed above, some of the unfortunate results and consequences that can be conceived of are:

- .Majority of the tax treaties executed by the Indian Government with the various countries provide for withholding tax rates

of 10 percent or 15 percent on royalties, fees for technical services (FTS), interests, etc, arising out of India to a non-resident taxpayer. The tax code proposes a uniform withholding tax rate of 20 percent for such receipts by non-residents. So taxpayers, who are residents of the relevant countries, who have negotiated such favourable treaties with the Indian Government, could suddenly become impacted.

- .Tax treaties provide for the concept of permanent establishment (PE) as a means to create taxable presence in India for non-resident taxpayers. The ambit of PEs under the Indian treaties, though more stringent than the general provisions relating to PEs under the OECD model of tax treaties, are far more relaxed as compared to the Indianised version of "business connection", as a means of creating taxable presence in India under the domestic tax laws. Incidentally, the Tax Code

has also proposed the abolition of the savings clause of an independent agent, which insulated non-resident taxpayers from creating a PE or taxable presence in India while dealing with third parties or subsidiary companies in India under an agency model, particularly under the arm's length scenario, which even the existing tax laws of India guarantees to non-resident taxpayers on almost equal footing as the tax treaties. Thus, with the coming into effect of the Tax Code, the favourable concept of PEs, so far as the existing tax treaties with the major countries are concerned, might stand withdrawn and further, non-resident taxpayers, while dealing with even third parties under an agency model, could be dragged into the Indian tax net.[152]

- .Some of the existing tax treaties provide for exemption from capital gains taxation in India, particularly in the context of disposal of shares in Indian companies, e.g., Mauritius, Singapore, Netherlands, Cyprus, etc. There have been several instances of litigation, where the Indian Revenue had contended that MNCs had attempted to misuse such tax exemptions through brass plate or paper companies set up in favourable treaty countries, without any commercial substance in the same. It is submitted that the same is a different matter altogether, however, the point remains that the capital gains tax exemption agreed by the Indian Government in the relevant tax treaties would be denied even for companies of substance. Incidentally, the Indian Singapore tax treaty even contains a "limitation of benefit" clause in the tax treaty, ensuring that only companies of substance get the benefits of the tax treaty.[153] However, if the Tax Code is intended to apply to the existing tax treaties, such benefits enshrined in the relevant tax treaties would be withdrawn even for bona fide and genuine cases.

---

[152] B.B Lal, N.Vasistha, Direct taxes, Income tax, wealth tax and tax planning, Dorling Kindersley, Delhi,p 24

[153] Timo Viherkenttä,Tax incentives in developing countries and international taxation: a study on the relationship between income tax incentives for inward foreign investment in developing countries and taxation of foreign income in capital-exporting countries, 1991, Kluwer pb. P 63-64

• .All the tax treaties provide a mechanism for settling tax disputes arising in any country through bilateral negotiations in the form of Mutual Agreement Procedure (MAP), where tax authorities of the countries negotiate with each other in order to settle disputes in an amicable manner. The scheme of MAP often provides an easy and effective solution to protracted tax litigation. Now, the Tax Code does not contain provisions for any such bilateral settlement of tax disputes through MAP. Thus, benefits available under the existing tax treaties signed with the major countries could be lost upon enactment of the Tax Code. The list given above is only illustrative and by no means exhaustive. There are so many other benefits guaranteed in tax treaties, which various sovereign countries had agreed with the Indian Government at the time of entering into of the tax treaties, by reposing confidence and faith in the tax system of the country existing at the relevant times of execution thereof that tax residents of such countries would be entitled to take recourse to such benefits in case of conflicts between the same and the domestic tax laws of India.[154] However, in case, through an unilateral act, the Indian Government were to suddenly withdraw all such benefits, which it had itself guaranteed through bilateral negotiations with various countries, the same might not be a welcome move. The issue of whether treaty benefits can be unilaterally overridden by a State through domestic laws is also a vexed one. Tax treaties are governed by the Vienna Convention. Though India is not a signatory to the Vienna Convention yet the principles of the Convention can nonetheless be applied to any Indian tax treaty, a proposition which finds support from the International Fiscal Association. Article 18 of the Convention provides that a State, which is party to a treaty, is obliged to refrain from acts which would defeat the object and purpose of the treaty. Article 26 of the Convention lays down the principles of *pacta sunt servanda*, i.e., "Every treaty

[154] Michael Lang, Multilateral tax treaties: new developments in international tax law, Kluwer Law International, p 5-7

in force is binding upon the parties to it and must be performed by them in good faith". Therefore, any unilateral act on the part of India to override existing tax treaties through the insertion of provisions in domestic tax laws would be conflict with Articles 18 and 26 of the Vienna Convention. Article 27 of the Convention provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. Article 27 of the Convention is without prejudice to Article 46, which provides that a State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance. The said Article further provides that a violation is manifest if it would be objectively evidenced to any State conducting itself in the matter in accordance with the normal practice and in good faith. When India had negotiated its existing tax treaties, clearly the domestic tax laws did not have any provision to the effect that a tax treaty could be unilaterally overridden by any subsequent amendment made to the domestic tax law, as is contemplated in the Tax Code. Therefore, the present proposal to override even existing tax treaties, if that is intended by the Parliament, would certainly not result in any violation of the internal laws of India, vis-à-vis the existing tax treaties, since the same was not manifest at the time of the negotiation thereof. Further, in any event, such violation would not concern the rule of internal laws of India of fundamental importance, which perhaps are the ones forming the pillars of the Indian constitution, namely, securing to all the citizens of India justice, social, economic and political; liberty of thought, expression, belief, faith and worship; equality of status and of opportunity; and the promotion among all the citizens of India, fraternity assuring the dignity of the individual and the unity

and integrity of the Nation, as are enshrined in the preamble to the Constitution. Revenue laws are not considered as laws of fundamental importance. These are required as fiscal measurements to

support the economy of the country. Therefore, any unilateral act on the part of the Parliament to override existing treaty benefits in the manner referred to above through amendment of domestic tax laws, would again contravene both Articles 27[155] and 46[156] of the Vienna Convention. It is true that the Constitutions of some countries, for example the USA, permit treaty overriding through domestic law, as under such Constitutions, treaties are ranked equal to the domestic law, with the result that they are subject to the rule *"lex posterior derogat legi[157] priori"*, i.e., later law overrides the prior law.[158] Again, there are countries like France, whose Constitutions clearly give treaties a superior position as compared to the domestic law, by virtue of which treaty overriding through amendment of domestic law is not permissible. Though the Indian Constitution does not fall under either of the two extreme categories, yet, there is support and comfort available from at least the Directive Principles of State Policy of the Constitution, in the form of Article 51, which interalia requires the State to foster respect for international law and treaty obligations. In case India would prefer to follow the US path in matters of tax treaties by specifically legislating that the later in law, namely provisions in domestic tax laws or tax treaties, would prevail, then clearly the same can only be made applicable to treaties executed after such legislation, since neither the provisions of the Indian Constitution nor those of the domestic tax laws of India, which existed at the times of execution of

---

155 Internal law and observance of treaties: A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.

156 Provisions of internal law regarding competence to conclude treaties:
1. A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.
2. A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

157It is the process of interpreting and applying legislation. Some amount of interpretation is always necessary when a case involves a statute. Sometimes the words of a statute have a plain and straightforward meaning. But in most cases, there is some ambiguity or vagueness in the words of the statute that must be resolved by the judge. To find the meanings of statutes, judges use various tools and methods of statutory interpretation, including traditional canons of statutory interpretation, legislative history, and purpose.

158 Michael Lang, Multilateral tax treaties: new developments in international tax law, Kluwer Law International, p 3-8

the existing tax treaties of India, gave such mandate. It is expected, based on the interpretation of the provisions of the Tax Code made earlier, that the proposed amendments should apply only to the new tax treaties to be entered into after coming into force of the Tax Code. However, in case the converse were to happen, i.e., the treaty overriding provisions under the principle of later law to prevail over prior law, would apply even to the existing tax treaties executed by India with various countries, the same may not receive unhindered blessings of the Constitution, quite apart from the fact that it may impact the eco political relationships with major countries. The matter needs to be handled with care and the Government could do well to bring out necessary clarifications in this regard in order to dispel doubts.

**ll. General anti avoidance rules (GAAR)**

Whenever the topic of tax avoidance comes up for discussion in the context of Indian taxation, the Supreme Court rulings in the cases of McDowell and Azadi Bachaon Andolan[159] automatically spring to memory. But in actual practice, the issue of tax avoidance, vis-à-vis the introduction of GAAR, actually encompasses a larger area than is covered by the said rulings.

Many people have the wrong notion that while in the case of McDowell[160], the Supreme Court had held that "substance should rule over form", in the later judgment, i.e., in the case of Azadi Bachaon Andolan, the Supreme Court, while blessing the capital gains tax exemption envisaged in the India-Mauritius tax treaty, had indirectly held that "form overrules substance". The notion is far from reality. The Supreme Court, even in the case of Azadi Bachaon Andolan, had held that substance in the transaction is the key for tax purposes. However, the fulcrum around which the said ruling of the Supreme Court rotated, was that a transaction, which otherwise was executed in accordance with

[159] 263 ITR 706
[160] 159 ITR 148 (SC),

law, would receive the blessings from the perspective of tax laws, even if the said transaction was entered into solely for the purposes of tax savings. For instance, when the India-Mauritius tax treaty did not contain a limitation of benefit clause, the Supreme Court held that a company incorporated in Mauritius, provided it was a resident of Mauritius under the taxation laws of the said country, would be entitled to the capital gains tax exemption envisaged under the relevant tax treaty on disposal of shares of an Indian company; and the Indian Revenue had no competence, in absence of any anti-avoidance rule embodied in either the tax treaty or the domestic tax laws of India, to question the commercial rationale of the ultimate parent company for routing the investment through Mauritius.

Thus, in view of the Supreme Court ruling in the case of Azadi Bachaon Andolan[161], so long as a transaction was not sham or prohibited by law, the same would need to receive blessings under taxation laws or treaties, vis-à-vis exemptions envisaged therein, and the Revenue was not competent to question the commercial necessity or justification for the taxpayer in transacting in any particular manner. Thus, a distinction may be made between the commercial substance and commercial justification/ rationale of a transaction. To satisfy commercial substance, the transaction has to be real, not a sham and also otherwise permissible in law, while to satisfy commercial necessity/ rationale of a transaction, the transaction, which though has commercial substance, has to also satisfy the rationale or need to be entered into, which cannot be solely for the purposes of tax. It is submitted that GAAR is not necessary or required to ensure commercial substance of a transaction, as the same would have been condemned even within the four corners or parameters of tax treaties or domestic tax laws. The utility of GAAR is really to check the breach or misuse of commercial justification/ rationale. Let us analyse the implications of GAAR in the context of international taxation and transfer pricing through some illustrations :

[161] (2003) 263 ITR 706 (SC)

## A. Thin capitalisation

There is a fundamental difference between Article 9 of tax treaties, which enables the international transfer pricing provisions of a country to be applied under the aegis of tax treaties, and the provisions of the international transfer pricing provisions of India. Article 9 of tax treaties provides that if conditions are made or imposed between two related parties, being tax residents of the respective two contracting states, in their commercial or financial relations, which differ from those, which would be made between third parties, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of the said enterprise and taxed accordingly.

On the other hand, the international transfer pricing provisions of India merely require the computation of any income arising from an international transaction between two related parties to be at arm's length price, where the term arm's length price has been defined to mean the price at which two independent parties would have transacted in uncontrolled conditions.

On a closer reading of the two provisions, it would appear that Article 9 of tax treaties has wider amplitude than the international transfer pricing laws of India. While the international transfer pricing laws of India mandate the arriving at an arm's length price under the given circumstance of happening of any particular transaction between related parties, Article 9 of tax treaties travels one step further in requiring justification of the transaction itself under the yard stick of arm's length principle. In other words, under the international transfer pricing laws of India, one would only need to prove that the price of transaction between two related parties is at arm's length, while under Article 9 of tax treaties, one would not only need to prove that the price of a transaction is at arm's length, but also that the transaction itself is executed under the principles of arm's length. Since,

under the current taxation regime, a taxpayer can choose to be governed by either a tax treaty or the domestic tax laws of India, being more favourable of the two, the larger amplitude envisaged under Article 9 of tax treaties could not be hitherto applied for transfer pricing purposes in India. Juxtaposing the aforesaid principle on the issue of thin capitalisation, the matter may be analysed as under:

- Let us say that a foreign parent has given a loan of US$500 million to its Indian subsidiary at an interest of three percent per anum.

- Under the international transfer pricing laws of India, it would be sufficient compliance if one were to establish that the rate of interest, i.e., three percent, is at arm's length. The Revenue currently does not have the mandate to question the arm's length nature of the transaction itself, namely whether, given the credit worthiness of the Indian subsidiary, a third party lender would have at all advanced a loan of US$500 million; and accordingly recharacterise the entire amount of US$500 million between loan and equity, by applying judicious transfer pricing methodology.

- On the other hand, Article 9 of tax treaties permit thin capitalisation questions also being asked, in addition to testing the arm's length price of the interest, as borne out by commentaries on the OECD model of tax treaties.

- GAAR now gives the power to the Revenue to challenge the quantum of interest deduction in the hands of the Indian subsidiary not only on the ground of the arm's length price of the interest, but also with reference to thin capitalisation issue, namely whether the entire amount of the loan could be actually held to constitute a loan or whether part of the same was really an equity in disguise.

• In fact, GAAR expressly empowers the Revenue to interalia recharacterise loan into equity, which the Revenue was hitherto not authorised to do under the existing international transfer pricing laws of India.

**B. Business restructuring**

The issue of business restructuring; and the implications of transfer pricing thereto, is a raging one across the world. Germany had already introduced specific legislation on business restructuring, while the OECD and the Australian Tax Office [ATO] had also released draft discussion papers on the relevant subject.

Let us say, that a full fledged marketing distributor operating in India is converted into a limited risk distributor by the foreign principal company. Based on the draft discussion papers issued by the OECD and the ATO, certain questions could crop up from the perspective of transfer pricing, namely:

• Whether the process of business conversion has necessary economic substance and commercial justification? and

• Whether the converted entity should receive an arm's length compensation for change in roles?

The two questions, though related, could nonetheless be independent. The first question is aimed to the very substance or acceptance of the business conversion and raises issues relating to the post facto implementation of the business conversion. On the other hand, the second question could operate even in a scenario that the business conversion per se has the backing of significant economic and commercial substance, so that transactions entered into post the business conversion between the various entities of the MNC group at arm's length would need to be respected and

accepted by the revenue departments of the various countries, however, a taxation event might nonetheless trigger at the stroke of the business conversion in the form of taxability of arm's length compensations in the hands of the converted entities in consideration to their conversion.[162]

Again, merely by paying a compensation for the business conversion, an MNC group might not be able to achieve a valid business conversion, acceptable in the eyes of transfer pricing regulations, in case the business conversion itself lacks economic substance and commercial justification. It is for this reason that one can state that the above questions could co-exist or even operate independently. The issue of whether a compensation needs to be paid to the converted entity and thus taxed in its hands, can be examined by the Indian Revenue under the aegis of the international transfer pricing laws of India, since there might be an actual transaction between the principal and the related party distributor at the time of conversion, in the form of transfer of assets, ideally intangibles, for which an arm's length price might be required to be charged. It is submitted that GAAR does not aim to cover the taxability of such compensation, which is generally referred to as "exit cost" under the parlances of transfer pricing. What GAAR could cover is the issue of acceptance or otherwise of the business conversion and post facto implementation of the business conversion, in case the business conversion per se does not have economic and commercial justification. Simply put, under the current international transfer pricing laws of India, in case the converted distributor can justify that after the business restructuring, all the significant peoples functions are actually carried out by the principal from abroad, such that its status or characterization as a limited risk distributor is a reality and not sham, then the Revenue cannot question the commercial justification/ rationale of the

---

[162] Direct Taxes Code 2009: Draconian "Anti-Avoidance" Measures?, Direct Taxes Code 2009: Draconian "Anti-Avoidance" Measures?, http://indiacorplaw.blogspot.com/2009/08/direct-taxes-code-2009-draconian-anti.html

exercise of business conversion, since as discussed earlier, the existing international transfer pricing laws of India do not permit questioning the arm's length nature of a transaction per se.

However, it appears that the Revenue could find such mandate under GAAR, where, while legislating the apathy towards "impressible avoidance arrangement", for the purposes of interalia disregarding the same for tax purposes, the said term has been interalia defined to mean a step in, or a part or whole of an arrangement, whose main purpose is to obtain a tax benefit and it creates rights, or obligations, which would not normally be created between persons dealing at arm's length. Thus, GAAR now appears to empower the Revenue to even question the economic and commercial justification/ rationale for participating in the business conversion, which, at the end of the day, is also in line with the draft discussion papers issued by the OECD and the ATO. However, it is submitted that GAAR needs to be applied with care and caution while examining the economic and commercial justification/ rationale for such business conversion in the context of an entity of an MNC group. In this regard, the Revenue would do well to follow the cautious guidance given by the OECD and ATO, namely[163] :

- It is quite possible that an independent entity may agree to operate with limited risks for more stable, albeit lower returns, compared to the option of operating with higher risks for a more volatile and potentially higher return. Instances can be found in cases where independent entities work as contract/ toll manufacturers or contract service providers. It has to be borne in mind that an option embedded with risk and correspondingly higher profits is not necessarily a better option for an independent entity, since the entity might not be worse off by selecting a less risky option, though the same reduces the potentiality of higher profits and losses.

1. [163] New Indian tax code – treaty override and anti- avoidance rules, www.pwc.com/en_IN/in/assets/pdfs/DTCtreatyoverrideGAAR.pdf

- Options available to an entity belonging to an MNC group could be limited, as compared to an independent entrepreneur, standing on its own. For instance, where an entity of an MNC group, works as either a licensed manufacturer or a marketing distributor under license arrangements with the principal company of the MNC group, it cannot straight away refuse to participate in an exercise of business restructuring whereby the entity is converted into either a contract/ toll manufacturer or commissionaire, as the case may be, and continue to operate in its existing capacity, since the principal company could merely terminate the license arrangements, thus rendering the relevant entity into a nullity.

- It would be a different matter altogether that the principal company might be required to pay arm's length compensation to the entity pursuant to conversion in relevant circumstances, however, the point to note is that the concerned entity in the MNC group might not have complete flexibility and liberty to refuse to participate in a business conversion in situations as above, a factor which the Revenue would need to bear in mind, while administering GAAR. GAAR also appears to empower the Revenue to challenge the economic and commercial justification for interposing intermediaries for availing tax treaty benefits, by nullifying the Supreme Court ruling in the case of Azadi Bachaon Andolan, as stated above. As discussed earlier, while the introduction of anti avoidance measures for treaties to be signed in future might have legislative and rational support, keeping in mind the overall taxation regime of the country, it could be difficult to apply the same to existing tax treaties, which had been executed under the aegis of the current tax laws of India and thus prior to the introduction of GAAR.

**Effect on Indo- Mauritius DTAA**

Although the proposed move may have implications on all the 75 DTAAs that the country has entered into till date, it will particularly be significant in the context of the agreement with Mauritius The Indian Government has been unsuccessful in its attempts to renegotiate the DTAA with Mauritius. Some of the high-value transactions have not been subjected to tax due to the Indo-Mauritius DTAA, tax experts pointed out.[164] However, it will have unintended consequences in areas such as technology purchases from abroad, he pointed out. The cost of overseas technology buy may go up for buyers here as they will have to fork out higher tax on royalty. The code proposes withholding tax of 20 per cent. On royalty payments. Royalty payments are generally made on gross basis. Most of the recent double taxation avoidance treaties we have entered into provide for withholding of 10 per cent. for royalty. If this new direct taxes code comes into play, the treaty benefits will not be available and therefore applicable withholding tax will be 20 percent for royalty.[165]

Assuming the new Direct Taxes Code comes into effect, the use of Mauritius as a holding company jurisdiction for India appears fraught with controversy. Because provisions under the new Direct Taxes Code would be later in time, they may prevail over the Indo-Mauritius tax treaty (and other treaties). Even if new tax treaties are entered into or old treaties renegotiated after the Code comes into force, anti avoidance and abuse provisions will come into play unless it is demonstrated to the satisfaction of the Indian revenue authorities that the holding arrangement is not an impermissible

[164] http://vstcases.com/news/shownews.asp?rid=AAANwAAABAAAQhMAAB
[165]August 13, 2009 Businessline, www.thehindubusinessline.

avoidance arrangement.[166] Under the draft Direct Taxes Code Bill, 2009, however, power has been given to the central government to enter into an agreement with the government of any country to provide relief from double taxation and also for the purpose of exchanging information for the prevention of evasion or avoidance of income tax. Further, the draft Code provides that neither a double taxation avoidance treaty nor the Code shall have preferential status by reason of its being a treaty or law and that, in the case of a conflict between the provisions of a treaty and the provisions of the Code, the one that is later in time will prevail. This is a significant departure. India already has entered into tax treaties with about 75 countries. Given that the draft Code would come into force on 1 April 2011 if enacted, it would be later in time with respect to all 75 tax treaties and may override them (including Mauritius). Of specific interest to current or would-be beneficiaries under the Indo-Mauritius treaty, the draft Code provides that any income from the transfer, directly or indirectly, of a capital asset situated in India will be deemed to accrue in India and thus will be taxable in India in the hands of a nonresident. Therefore, any transfer of an Indian company's shares by a Mauritius holding company may become liable to tax in India under the new Direct Taxes Code (once enacted) without relief from the treaty.

---

166 Direct tax code propose to remove the difference between tax avoidance and tax evasion http://www.taxguru.in/income-tax/direct-tax-code-propose-to-remove-the-difference-between-tax-avoidance-and-tax-evasion.html#ixzz0r0FtMnRJ

# CHAPTER 7

## Final Thought

The international taxation regime exists through bilateral tax treaties based upon model treaties, developed by the OECD and the UN and others between the Contracting States. However, the international tax regime has to be restructured continuously so as to respond to the current challenges and drawbacks.

However, the last few years have seen a change in the approach of the States in the wake of wide reports of extensive money laundering and the tax evasion. To cop up with treaty shopping which has been a very challenging task under different international tax treaties, various models and clauses are in practice to maintain the balance between use and misuse of tax treaties. As consequences, a lot of countries are adopting a "Limitation of Benefits" clause in the tax treaties so as o restrict third parties from taking advantage of tax treaties between two other states.

India has also entered into a wide network of tax treaties with various countries all over the world to facilitate free flow of capital into and from India. Mauritius being one among them and has been a subject of constant treaty shopping since more than a decade causing tax evasion and loss to exchequer. It can be suggested that some changes in agreement itself by negotiation between two countries should be made that it can be avoided. To enjoy treaty benefits, the new entity should comply with the test of business purpose. There should be genuine business activities. This is meant to discourage treaty shopping. This provision was incorporated in our treaty with Singapore signed in June 2005. Article 24 of the Indo-US DTAA also has such a provision. It is necessary that our tax code should have an anti-tax avoidance clause on the lines of the Singapore model. A company must be of substance to get DTAA benefits. For quite some time, tax jurists have been saying that funds are being re-routed through tax havens to take advantage of treaty provisions.

The tax law should be amended to plug the dichotomy between legal and beneficial ownership of shares in the case of controlled foreign corporation. The OECD had recommended that the Government ask for upfront disclosure of beneficial ownership and control information on the formation of companies to prevent tax evasion.

To prevent abuse of the treaty provisions, our tax treaties should be renegotiated and the income-tax law amended on the lines of the American and Singapore code. The new proposed Tax code might be an answer to the issue but it needs to be reconciled with the international legal standards and obligations under International law.

# BIBLIOGRAPHY

## ARTICLES AND JOURNALS


1. Avi-Yonah Reuven S, "The Structure of International Taxation: A Proposal for Simplification", (1996) 74 *Tex. L. Rev.*
2. Avi-Yonah Reuven S, "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State", (2000) 113 *Harv. L. Rev.*
3. Brown Karen B, "Allowing Tax Laws to Cross Borders to Defeat international tax Avoidance: The Convention on Mutual Assistance in Tax Matters", (1989) 15 *Brooklyn L. Int'l L.*
4. Fleming Clifton J Jr, Peroni Robert J, Shay Stephen E, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income", (2001) 5 *Fla. Tax Rev.*
5. Ceruzzi Louis L, "United States International Taxation: Jurisdiction to Tax and Accommodation Among Competing Tax Systems, (1979) *N.Y.J. Int'l & Comp. L.*
6. Dagan Tsilly, "The Tax Treaties Myth". (2000) 32 *N.Y.U.J. Int'l L. & Pol.*
7. Frisch Daniel J, "The Economics of International Tax Policy: Some Old and New Approaches", (1990) 47 *Tax Notes.*
8. Wattel and Manes, "The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Thx Treaties", in *Eur. Tax.*, 2003.
9. Owens, "The Main Differences between the OECD and the United Nations Model Conventions", in Vann (ed), OECD Proceedings: Tax Treaties — Linkeage.s Between OECD Member Countries and Dynamic Non.Member Economies, OECD, Paris, 1996.
10. Van Weeghel, *The Improper Use of Tax Treaties, Deventer, 1998,*

11. Van Raad, "Interpretation and Application of Tax Treaties by Tax Courts". in Eur, Tax., 1996.

12. Ellis, "The Influence of the OECD Commentaries on Treaty Interpretation — Response to Prof. Dr. Klaus Vogel", 2000 Hudson David M and Turner Daniel C, "International and Interstate Approaches to Taxing Business Income", (1984) 6 *J.Int'l. l. Bus.*

13. Wattel and Manes, "The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties", in Eur. Tax,, 2003

14. "One True Meaning" of a Tax Treaty, John F. Avery Jones, IBFD Bulletin June 2001.

15. Van Raad, "Dutl Residence", in *Eur. Tax.*, p. 241 et seq. and Avery Jones and Bobbett, "Triangular Treaty Problems: A Summary of the Discussion in Seminar at the IFA Congress in London", 1999.

16. Lang, "How Significant are the Amendments of the OECD Commentary Adopted after the Conclusion of a Tax Treaty?", in Dir. post. trib. inter., 2002.

17. David, Oliver. "Access to tax Treaties", in *Int.*, 1989

18. Ward, "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries", Canada. Tax Journal, 1996.

19. Romano, "The Evolving Concept of 'Place of Effective Management' as a Tie Breaker Rule under the OECD Model Convention and Italian Law", in Eur. Tax., 2001. Irish Charles R, "International Double Taxation Agreements and Income Taxation at Source", (1974) 23 *Int'l & Comp. L.Quarterly/*

20. Wijnen and Marco Magenta, "The UN Model in Practice", 51. Bulletin for International Fiscal Documentation 12.

21. Kingson Charles I, "The Coherence of International Taxation"(1981) 6 *Colum. L. Rev.*

22. Musgrave Peggy B, "Revisiting The Theory of International Income Taxation: Sovereignty, Entitlement and Cooperation in International Taxation", (2001) 26 *Brooklyn J. Int'l* L.

23. Ward, "Abuse of Tax Treaties", in Albert and Van Raad (edt.), Essays on International Taxation, London-The Hague-Boston, 1993 (Series on International Taxation, no. 15)

24. Equitable Tourism Options (EQUATIONS), Bilateral Trade Agreements – Issues and Concerns for India,15 Mar 05-EQUATIONS

## BOOKS


- International Tax Law edit. Andrea Amatucci, kluwer Law International, Delhi, 2008.
- G. L. Pophale, Tax treaties between India and foreign countries, Manaktalas, 1996
- B.B Lal, N.Vasistha, Direct taxes, Income tax, wealth tax and tax planning, Dorling Kindersley, Delhi
- Bimal N. Patel, India and international law, Volume1 and 2, Martinus Nijhoff Publishers, Dordrecht.
- Avery Jones John F, De Broe Luc, Ellis Maarten J, Van Raad Ellis, Fontaneau Pierre, Fontaneau Pierre-Marie, Lenz Raoul, Torrione Henri, Miyatake Toshio, Roberts Sidney I, Goldberg Sanford H, Strobl Jakob, Killius Jurgen, Uckmar Victor, Giuliana Federico, Maisto Guglielmo, Vann Richard J, and Ward David A, "Tax Treaty Problems Relating to Source", [1998]
- Van Raad, "The Netherlands Model Income Tax Treaty", in mt.. 1988,241
- Lyons & Van Waardenburg, "Some Aspects of International Tax Treaty Strategy of the Netherlands", 1988,
- [1] Swapna Sandesh Sinha , Comparative Analysis of FDI in China and India: Can Laggards Learn from Leaders?, Universal-Publishers, Delhi, 2008
- Van Raad (ed), Model Income Tax Treaties, Deventer. 1983
- Doernberg and Van Raad, The 1996 United States Model Income Tax Convention, The Hague, 1997
- Doernberg Richard L and Hinnekens Luc, *Electronic Commerce and International Taxation* (The Hague, Kluwer Law International, 1999)

- Easson Alex, "Taxing International Taxation", in Krever Richard (ed), *Tax Conversations – A Guide to the Key Issues in the Tax Reform Debate – Essays in Honour of John G. Head* , (London, Kluwer Law International, 1997)
- Gravelle, "Tax Treaties: Concepts, Objectives and 'types", 1988
- Edwards-Ker, Tax Treaty Interpretations, Euromoney Publications, London, 2004
- Steichen, "Tax Treaty Interpretation in Luxembourg", in Lang (ed). Tax Treaty Interpretation, Vienna. 2001.
- Avery Jones, "Tax Treaty Interpretation in the United Kingdom", in Lang (ed), Tax Treaty Interpretation, Linde, Vienna, 2001
- Vogel and Prokisch (*General Report*, in Cahiers, vol. LXX VIlla, 1993
- Vogel on Double Taxation Conventions, 3rd edition ,Deventer, The Netherlands: Kluwer, 1997.
- Ault, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", in Alpert and Vait Raad, Essays on International Taxation. To Sidney I. Roberts, 1993.
- Skaar, Permanent Establishment, Deventer, 1991;
- The Development in Different Countries of the Concept of a Permanent Establishment", in Cahiers, vol. 52, Deventer, 1987;
- Van Raad, "International Coordination of Tax Treaty Interpretation and Application", *in Int.*, 2001
- Avery Jones, "The Effect of Changes in the OECD Commentaries after a Treaty is Concluded",.2002
- Schaffner, "The OECD Report on the Application of Tax Treaties to Partnerships", 2000
- Roderick Millar,Doing Business with India, GMB Publication ltd, Delhi, 2006

## DOCUMENTS


- The Vienna Convention on law of Treaties.1969
- India and Mauritus treaty on taxation. 1992
- The Nordic Convention on income and capital entered into by Denmark, Finland, Iceland, Norway , Sweden and concluded in 1983 and repealed in 1987.
- OECD, Model Tax Convention.
- Report on double taxation submitted to the Financial committee by Professor Bruins , Einaudi, Seligman and Sir Josiah Stamp, Leauge of Nations Doc. E.F.S 73 .F.19 (Geneva 1923)
- London and Mexico Model Tax convention, Commentary and text, League of Nations Doc. C 88. M 1946.
- Mogle, United States Treaty Policy, FT. World Tax Report. 1983. Burke Edmund, Speech on American Taxation April 19, 1774, in Burke, *Selected Works: Thoughts on the Present Discontents - The Two Speeches on America,* (Vol. 1), Payne EJ MA (Ed.) (Alabama, Legal Classics Library, 1990)
- IFA, UN Draft Model Tax Convention, Deventer, 1979.
- Vogel, "The Influence of the OIJCD Commentaries on Treaty Interpretation", 2000,
- Avery Jones, "The Effect of Changes in the OECD Commentaries after a Treaty is Concluded", 2002.
- Irish Revenue, *Report on Electronic Commerce and the Irish Tax System,* June 1999.
- League of Nations, *Double Taxation and Tax Evasion,* Report and Resolution submitted by the Technical Experts to the Financial Committee of the League of Nations (C. 115. M. 55. 1925. II) Geneva, 1925)

- National Foreign Trade Council, *International Tax Policy for the 21st Century* (New York, National Foreign Trade Council,2001)


**WEBSITES VISITED BETWEEN 05.01.2010 TO 30.05.2010**


- http://www.lowtax.net/lowtax/html/jmuoltr.html
- http://www.maurinet.com/busoff1.html
- http://www.mondaq.com/article.asp?articleid=55688
- http://www.lowtax.net/lowtax/html/jmuoltr.html
- http://www.maurinet.com/busoff1.html
- http://www.internationaltaxreview.com/default.asp?Page=9&PUBid=210&ISS=13240&SID=488912
- http://www.thehindubusinessline.com/2007/05/09/stories/2007050900990700.htm
- http://www.revenue.ie/services/e_comm.htm
- http://finmin.nic.in/dtcode/Direct%20Taxes%20Code%20Bill%202009.pdf
- http://www.india-briefing.com/news/law-threaten-mauritius-tax-treaty-2327.html/
- http://www.pwc.com/en_IN/in/assets/pdfs/DTCtreatyoverrideGAAR.pdf
- http://www.deloitte.com/assets/Dcom
- http://vstcases.com/news/shownews.asp?rid=AAANwAAABAAAQhMAAB
- http://www.shivakantjha.org/openfile.php?filename=articles/treaty_shopping.htm
- http://indiacorplaw.blogspot.com/2009/08/direct-taxes-code-2009-draconian-anti.html

# *Annexure*

## AGREEMENT OF 24TH AUGUST, 1982

CONVENTION BETWEEN THE GOVERNMENT OF THE REPUBLIC OF INDIA AND THE GOVERNMENT OF MAURITIUS FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES OF INCOME AND CAPITAL GAINS.

The Government of the Republic of India and the Government of Mauritius.

DESIRING to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment.

HAVE AGREED as follows:

### CHAPTER I

### SCOPE OF THE CONVENTION

**Article 1**

**Personal Scope**

This Convention shall apply to persons who are residents of one or both of the Contracting States

**Article 2**

**Taxes Covered**

**1.** The existing taxes to which this Convention shall apply are:

*(a)* in the case of India:

**(i)** the income-tax including any surcharge thereon imposed under the Income-tax Act, 1961 (43 of 1961);

**(ii)** the surtax imposed under the Companies (Profits) Surtax Act, 1964 (7 of 1964); (hereinafter referred to as "Indian tax").

*(b)* in the case of Mauritius:

the income tax (hereinafter referred to as "Mauritius tax").

**2.** This Convention shall also apply to any identical of substantially similar taxes which are imposed by either Contracting State after the date of signature of the present Convention in addition to, or in place of, the existing taxes referred to in paragraph 1 of this Article.

**3.** The competent authorities of the Contracting States shall notify to each other any significant changes which are made in their respective taxation laws.

## CHAPTER II

## DEFINITIONS

### Article 3

### General Definitions

**1.** For the purposes of this Convention, unless the context otherwise requires:

*(a)* the term 'India' means the territory of India and includes the territorial sea and airspace above it as well as any other maritime zone referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (Act No. 80 of 1976), in which India has certain rights and to the extent that these rights can be exercised therein as if such maritime zone is a part of the territory of India;

*(b)* the term 'Mauritius' means all the territories, including all the islands, which, in accordance with the laws of Mauritius, constitute the State of Mauritius and includes:

**(i)** the territorial sea of Mauritius; and

**(ii)** any area outside the territorial sea of Mauritius which in accordance with international law has been or may hereafter be designated, under the laws of Mauritius concerning the Continental Shelf as an area within which the rights of Mauritius with respect to the sea-bed and subsoil and their natural resources may be exercised;

*(c)* the terms 'a Contracting State' and the other Contracting State' mean India or Mauritius as the context requires;

*(d)* the term 'tax' means Indian tax or Mauritius tax as the context requires, but shall not include any amount which is payable in respect of any default or omission in relation to the taxes to which this Convention applies or which represents a penalty imposed relating to those taxes;

*(e)* the term 'person' includes an individual, a company and any other entity, corporate or non-corporate, which is treated as a taxable unit under the taxation laws in force in the respective Contracting States;

*(f)* the term 'company' means any body corporate or any entity which is treated as a company or a body corporate under the taxation laws in force in the respective Contracting States;

*(g)* The term 'enterprise of a Contracting State and 'enterprise of the other Contracting State' mean respectively an industrial, mining, commercial, plantation or agricultural enterprise or similar undertaking carried on by a resident of a Contracting State and an industrial, mining, commercial, plantation or agricultural enterprise or similar undertaking carried on by a resident of the other Contracting State;

*(h)* the term 'competent authority' means in the case of India the Central Government in the Ministry of Finance (Department of Revenue) or their authorised representative; and in the case of Mauritius, the Commissioner of Income Tax or his authorised representative;

*(i)* the term 'national' means any individual possessing the nationality of a Contracting State and any local person, partnership or association deriving its status from the laws in force in the Contracting State;

*(j)* the term 'international traffic' means any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State, except when the ship or aircraft is operated by the enterprise solely between places in the other Contracting State.

**2.** In the application of the provisions of this Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws in force of that Contracting State relating to the areas which are the subject of this Convention.

**Article 4**

**Residents**

**1.** For the purposes of the Convention, the term "resident of a Contracting State" means any person who under the laws of that State, is liable to taxation therein by reason of his domicile, residence, place or management or any other criterion of similar nature. The terms "resident of India" and "resident of Mauritius" shall be construed accordingly.

**2.** Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his residential status for the purposes of this Convention shall be determined in accordance with the following rules;

*(a)* he shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (hereinafter referred to as his "centre of vital interests");

*(b)* if the Contracting State in which he has his centre of vital interest cannot be determined, or if he does not have a permanent home available to him in either

Contracting State he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;

*(c)* if he has an habitual abode in both Contracting State or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;

*(d)* if he is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

**3.** Where by reason of the provision of paragraph 1, a person other than an individual is a resident of both the Contracting States, then it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated.

**Article 5**

**Permanent Establishment**

**1.** For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of the enterprise is wholly or partly carried on.

**2.** The term 'permanent establishment' shall include:

*(a)* a place of management;

*(b)* a branch;

*(c)* an office;

*(d)* a factory;

*(e)* a workshop;

*(f)* a warehouse, in relation to a person providing storage facilities for others;

*(g)* a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;

*(h)* a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on;

*(i)* a building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than nine months.

**3.** Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:

*(a)* the use of facilities solely for the purpose of storage or display of merchandise belonging to the enterprise;

*(b)* the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

*(c)* the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

*(d)* the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information for the enterprise;

*(e)* the maintenance of a fixed place of business solely--

**(i)** for the purpose of advertising,

**(ii)** for the supply of information,

**(iii)** for scientific research, or

**(iv)** for similar activities,

which have a preparatory or auxiliary character for the enterprise.

**4.** Notwithstanding the provisions of paragraphs 1 and 2 of this Article, a person acting in a Contracting State for or on behalf of an enterprise of the other Contracting State (other than an agent of an independent status to whom the provisions of paragraph 5 apply) shall be deemed to be a permanent establishment of that enterprise in the first-mentioned State if:

*(i)* he has and habitually exercises in that first mentioned State, an authority to conclude contracts in the name of the enterprise unless his activities are limited to the purchase of goods or merchandise for the enterprise; or

*(ii)* he habitually maintains in that first-mentioned State a stock of goods or merchandise belonging to the enterprise from which he regularly fulfills orders on behalf of the enterprise.

**5.** An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted exclusively or almost exclusively on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.

**6.** The fact that a company, which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise) shall not, of itself, constitute either company a permanent establishment of the other.

## CHAPTER III

## TAXATION OF INCOME

### Article 6

### Income from Immovable Property

**1.** Income from immovable property may be taxed in the Contracting State in which such property is situated.

**2.** The term "immovable property" shall be defined in accordance with the law and usage of the Contracting State in which the property is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, oilwells, quarries and other places of extraction of natural resources, ships, boats and aircraft shall not be regarded as immovable property.

**3.** The provisions of paragraph 1 shall apply to income derived from the direct use letting, or use in any other form of immovable property.

**4.** The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

### Article 7

### Business Profits

**1.** The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

**2.** Subject to the provisions of paragraph 3 of this Article, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. Where the correct amount of profits attributable to a permanent establishment cannot be readily determined or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis.

**3.** In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

**4.** No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

**5.** For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

**6.** Where profits include items or income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

**Article 8**

**Shipping and Air Transport**

**1.** Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

**2.** If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship is a resident.

**3.** The provisions of paragraph 1 of this Article shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

**4.** For the purposes of paragraph 1, interest on funds connected with the operation of ships or aircraft in international traffic shall be regarded as profits from the operation of such ships or aircraft, and the provisions of Article 11 shall not apply in relation to such interest.

**5.** The term "operation of ships or aircraft" shall mean business of transportation of persons, mail, livestock or goods, carried on by the owners or lessees or charterers of the ships or aircraft, including the sale of tickets for such transportation on behalf of other enterprises, the incidental lease of ships or aircraft and any other activity directly connected with such transportation.

**Article 9**

**Associated Enterprises**

Where:

*(a)* an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

*(b)* the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

**Article 10**

**Dividends**

**1.** Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

**2.** However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and accordingly to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed:

*(a)* five per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 10 per cent of the capital of the company paying the dividends;

*(b)* fifteen per cent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

**3.** Notwithstanding the provisions of paragraph 2, dividends paid by a company which is a resident of Mauritius to a resident of India may be taxed in Mauritius and according to the laws of Mauritius, as long as dividends paid by companies which are residents of Mauritius are allowed as deductible expenses for determining their taxable profits. However, the tax charged shall not exceed the rate of the Mauritius tax on profits of the company paying the dividends.

**4.** The term 'dividends' as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident.

**5.** The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

**6.** Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed

profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

**Article 11**

**Interest**

**1.** Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

**2.** However, subject to the provisions of paragraphs 3 and 4 of this Article, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State.

**3.** Interest arising in a Contracting State shall be exempt from tax in that State provided it is derived and beneficially owned by:

*(a)* the Government or a local authority of the other Contracting State;

*(b)* any agency or entity created or organised by the Government of the other Contracting State; or

*(c)* any bank carrying on a bonafide banking business which is a resident of the other Contracting State.

**4.** Interest arising in a Contracting State shall be exempt from tax in that Contracting State to the extent approved by the Government of that State if it is derived and beneficially owned by any person (other than a person referred to in paragraph 3) who is a resident of the other Contracting State provided that the transaction giving rise to the debt-claim has been approved in this regard by the Government of the first-mentioned Contracting State.

**5.** The term 'interest' as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and, in particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

**6.** The provisions of paragraphs 1, 2 3, and 4 shall not apply if the recipient of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

**7.** Interest shall be deemed to arise in a Contracting State when the payer is that Contracting State itself, a political sub-division, a local authority or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by that permanent establishment, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment is situated.

**8.** Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

**Article 12**

**Royalties**

**1.** Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

**2.** However, such royalties may also be taxed in the Contracting State in which they arise, and according to the law of that State, but the tax so charged shall not exceed 15 per cent of the gross amount of the royalties.

**3.** The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, and films or tapes for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

**4.** The provisions of paragraphs 1 and 2 shall not apply if the recipient of the royalties, being a resident of a Contracting State carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

**5.** Royalties shall be deemed to arise in a Contracting State when the payer is that Contracting State itself, a political sub-division, a local authority or a resident of that State, where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment is situated.

**6.** Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In that case, the excess part of the payments shall remain taxable according to the laws of each contracting State, due regard being had to the other provisions of this Convention.

**Article 13**

**Capital Gains**

**1.** Gains from the alienation of immovable property, as defined in paragraph 2 of Article 6, may be taxed in the Contracting State in which such property is situated.

**2.** Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other State.

**3.** Notwithstanding the provisions of paragraph 2 of this Article, gains from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

**4.** Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 of this Article shall be taxable only in that State.

**5.** For the purpose of this Article, the term "alienation" means the sale, exchange, transfer or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States.

**Article 14**

**Independent Personal Services**

**1.** Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other Contracting State but only so much of it as is attributable to that fixed base.

**2.** The term 'professional services' includes especially independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

**Article 15**

**Dependent Personal Services**

**1.** Subject to the provisions of Articles 16, 17, 18, 19, 20 and 21, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only

in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other Contracting State.

**2.** Notwithstanding the provisions of paragraph 1 of this Article, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in first-mentioned State if:

*(a)* the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the relevant "previous year" or "year of income", and

*(b)* the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

*(c)* the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

**3.** Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment exercised abroad, a ship or aircraft in international traffic, may be taxed only in the Contracting State in which the place of effective management of the enterprise is situated.

**Article 16**

**Directors' Fees**

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other Contracting State.

**Article 17**

**Artistes and Athletes**

**1.** Notwithstanding the provisions of Articles 14 and 15, income exercised by an entertainer or an athlete in his capacity as such, and motion picture, radio or television artistes and musicians, and by athletes, from their personal activities as much may be taxed in the Contracting State in which these activities are exercised.

**2.** Where income is derived from personal activities exercised by an entertainer or an athlete in his capacity as such, and accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the State in which the activities of the entertainer or athlete are exercised.

**3.** Notwithstanding the provisions of paragraph 1 of this Article, income derived by an entertainer or an athlete who is a resident of a Contracting State from his personal activities as such exercised in the other Contracting State, shall be taxable only in the first-mentioned Contracting State, if those activities in the other

Contracting State, are supported wholly or substantially from the public funds of the first-mentioned Contracting State, including any of its political sub-divisions or local authorities.

**4.** Notwithstanding the provisions of paragraph 2 of this Article and Articles 7, 14 and 15, where income is derived from personal activities exercised by an entertainer or an athlete in his capacity as such in a Contracting State and accrues not to the entertainer or athlete himself but to another person, that income shall be taxable only in the Contracting State, if that other persons is supported wholly or substantially from the public funds of that other Contracting State, including any of its political sub-divisions or local authorities.

**Article 18**

**Governmental Functions**

**1.** Remuneration, other than pension, paid by the Government of a Contracting State to an individual who is a national of that State in respect of services rendered to that State, shall be taxable only in that State.

**2.** Any pension paid by the Government of a Contracting State to an individual who is a national of that State, shall be taxable only in that Contracting State.

**3.** The provisions of paragraphs 1 and 2 of this Article shall not apply to remuneration and pensions in respect of services rendered in connection with any business carried on by the Government of either of the Contracting States for the purpose of profit.

**4.** The provisions of paragraph 1 of this Article shall likewise apply in respect of remuneration paid under a development assistance programme of a Contracting State, out of funds supplied by that State to a specialist or volunteer seconded to the other Contracting State with the Consent of that other State.

**5.** For the purpose of this Article, the term "Government" shall include any State Government or local or statutory authority of either Contracting State and, in particular, the Reserve Bank of India and the Bank of Mauritius.

**Article 19**

**Non-governmental Pensions and Annuities**

**1.** Any pension, other than a pension referred to in Article 18, or any annuity derived by a resident of a Contracting State from sources within the other Contracting State shall be taxed only in the first-mentioned Contracting State.

**2.** The term "pension" means a periodic payment made in consideration of past services or by way of compensation for injuries received in the course of performance of services.

**3.** The term "annuity" means a stated sum payable periodically at stated times during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

**Article 20**

**Students and Apprentices**

**1.** A student or business apprentice who is or was a resident of one of the Contracting States immediately before visiting the other Contracting State and who is present in that other Contracting State solely for the purpose of his education or training shall be exempt from tax in that other Contracting State on;

*(a)* payments made to him from sources outside that other Contracting State for the purposes of his maintenance, education or training; and

*(b)* remuneration from employment in that other Contracting State, in an amount not exceeding Rs. 15,000 in Indian currency or its equivalent in Mauritius rupees at the parity rate of exchange during any "previous year" or "year of income", as the case may be, provided that such employment is directly related to his studies or is undertaken for the purpose of his maintenance.

**2.** The benefits of this Article shall extend only for such period of time as may be reasonable or customarily required to complete the education or training undertaken, but in no event shall any individual have the benefits of this Article for more than five consecutive years from the date of his first arrival in that other Contracting State.

**Article 21**

**Professors, Teachers and Research Scholars**

**1.** A Professor, Teacher and Research Scholar who is or was a resident of one of the Contracting States immediately before visiting the other Contracting State at the invitation of that other Contracting State or of a university, college, school or other approved institution, in that other Contracting State for the purpose of teaching or engaging in research, or both, at the university, college, school or other approved institution, shall be exempt from tax in that other Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date of his arrival in that other Contracting State.

**2.** This Article shall not apply to income from research if the research is undertaken primarily for the private benefit of a specific person or persons.

**3.** For the purposes of this Article and Article 20 an individual shall be deemed to be a resident of a Contracting State if he is resident in that Contracting State in the "previous year" or the "year of income" as the case may be, in which he visits the other Contracting State or in the immediately preceding "previous year" or the "year of income".

**4.** For the purpose of paragraph 1, "approved institution", means an institution which has been approved in this regard by the competent authority of the concerned Contracting State.

**Article 22**

**Other Income**

**1.** Subject to the provisions of paragraph 2 of this Article, items of income of a resident of a Contracting State, wherever arising, which are not expressly dealt with in the foregoing Articles of this Convention, shall be taxable only in that Contracting State.

**2.** The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

## CHAPTER IV

## METHODS FOR ELIMINATION OF DOUBLE TAXATION

**Article 23**

**Elimination of Double Taxation**

**1.** The laws in force in either of the Contracting States shall continue to govern the taxation of income in the respective Contracting States except where provisions to the contrary are made in this Convention.

**2.** *(a)* The amount of Mauritius tax payable under the laws of Mauritius and in accordance with the provisions of this Convention, whether directly or by deduction, by a resident of India, in respect of profits or income arising in Mauritius, which has been subjected to tax both in India and in Mauritius, shall be allowed as a credit against the Indian tax payable in respect of such profits or income provided that such credit shall not exceed the Indian tax (as computed before allowing any such credit) which is appropriate to the profits or income arising in Mauritius. Further, where such resident is a company by which surtax is payable in India, the credit aforesaid shall be allowed in the first instance against income-tax payable by the company in India and as to the balance, if any, against surtax payable by it in India.

*(b)* In the case of a dividend paid by a company which is a resident of Mauritius to a company which is a resident of India and which owns at least 10 per cent of the shares of the company paying the dividend, the credit shall take into account (in addition to any Mauritius Tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Mauritius tax payable by the company in respect of the profits out of which such dividend is paid.

**3.** For the purposes of the credit referred to in paragraph 2, the term 'Mauritius tax payable' shall be deemed to include any amount which would have been payable as Mauritius tax for any year but for an exemption or reduction of tax granted for that year or any part thereof under:

**(i)** sections 33, 34, 34A and 34B of the Mauritius Income-tax Act (41 of 1974);

**(ii)** any other provision which may subsequently be made granting an exemption or reduction of tax which the competent authorities of the Contracting States agree to be for the purposes of economic development;

**4.** *(a)* The amount of Indian tax payable under the laws of India and inaccordance with the provisions of this Convention, whether directly or by deduction, by a resident of Mauritius, in respect of profits or income arising in India, which has been subjected to tax both in India and Mauritius shall be allowed as a credit against Mauritius tax payable in respect of such profits or income provided that such credit shall not exceed the Mauritius tax (as computed before allowing any such credit) which is appropriate to the profits or income arising in India.

*(b)* In the case of a dividend paid by a company which is a resident of India to a company which is a resident of Mauritius and which owns at least 10 per cent of the shares of the company paying the dividend, the credit shall take into account (in addition to any Indian Tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Indian tax payable by the company in respect of the profits out of which such dividend is paid).

**5.** For the purposes of the credit referred to in paragraph 4, the term 'Indian tax payable' shall be deemed to include any amount by which tax has been reduced by the special incentive measures under:

**(i)** sections 10(4), 10(4A), 10(6), (viia), 10(15)(iv), 10(28), 10A, 32A, 33A, 35B, 54E, 80HH, 80HHA, 80-I, 80L of the Indian Income-tax Act, 1961 (43 of 1961),

**(ii)** any other provision which may subsequently be enacted granting a reduction of tax which the competent authorities of the Contracting States agree to be for the purposes of economic development.

**6.** Where under this Convention a resident of Contracting State is exempt from tax in that Contracting State in respect of income derived from the other Contracting State, then the first mentioned Contracting State may, in calculating tax on the remaining income of that person, apply the rate of tax which would have been applicable if the income exempted from tax in accordance with this Convention had not been so exempted.

## CHAPTER V

## SPECIAL PROVISIONS

### Article 24

### Non-discrimination

**1.** The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

**2.** The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances.

**3.** Nothing contained in this Article shall be construed as obliging a Contracting State to grant persons not resident in that State any personal allowances, reliefs, reductions and deductions for taxation purpose which are by law available only to persons who are so resident.

**4.** Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly by one or more residents of the other Contracting State, shall not be subjected in the first mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first mentioned State are or may be subjected in the same circumstances.

**5.** In this Article, the term "taxation" means taxes which are the subject of this Convention.

### Article 25

### Mutual Agreement Procedure

**1.** Where a resident of a Contracting State considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident. This case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Convention.

**2.** The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the laws of the Contracting States.

**3.** The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for in the elimination of double taxation in cases not provided for the Convention.

**4.** The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

**Article 26**

**Exchange of Information or Document**

**1.** The competent authorities of the Contracting States shall exchange such information or document as is necessary for carrying out the provisions of this Convention or for prevention of evasion of taxes which are the subject of this Convention. Any information or document so exchanged shall be treated as secret but may be disclosed to persons (including courts or other authorities) concerned with the assessment, collection, enforcement, investigation or prosecution in respect of the taxes which are the subject of this Convention, or to persons with respect to whom the information or document relates.

**2.** The exchange of information or documents shall be either on a routine basis or on request with reference to particular cases or both. The competent authorities of the Contracting States shall agree from time to time on the list of the information or documents which shall be furnished on a routine basis.

**3.** The provisions of paragraph 1 shall not be construed so as to impose on a Contracting State the obligation:

*(a)* to carry out administrative measures at variance with the laws or administrative practice of that or of the other Contracting State;

*(b)* to supply information or documents which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

*(c)* to supply information or documents which would disclose any trade, business, industrial, commercial or professional secret or trade process or information the disclosure of which would be contrary to public policy.

**Article 27**

**Diplomatic and Consular Activities**

Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials - under the general rules of international law or under the provisions of special agreement.

## CHAPTER VI

## FINAL PROVISIONS

### Article 28

### Entry into Force

Each of the Contracting States shall notify to the other, the completion of the procedures required by its law for the bringing into force of this Convention. The Convention shall enter into force on the date of the later of these notifications and shall thereupon have effect:

*(a)* in India, in respect of income and capital gains assessable for any assessment year commencing on or after 1st April, 1983;

*(b)* In Mauritius, in respect of income and capital gains assessable for any assessment year commencing on or after 1st July, 1983.

### Article 29

### Termination

The Convention shall remain in force indefinitely but either of the Contracting States may, on or before the thirtieth day of June in any calendar year beginning after the expiration of a period of five years from the date of its entry into force, give the other Contracting State through diplomatic channels, written notice of termination and in such event, this convention shall cease to have effect:

*(a)* in India, in respect of income and capital gains assessable for the assessment year commencing on 1st day of April in the second calendar year next following the calendar year in which the notice is given, and subsequent years;

*(b)* in Mauritius, in respect of income and capital gains assessable for the assessment year commencing on 1st day of July in the second calendar year next following the calendar year in which the notice is given, and subsequent years.