Anti Avoidance Rules and Treaty Shopping (including Limitation of Benefits)

CA Sanjay Tolia
December 2014

Agenda

- **Treaty shopping - Concept**
- Key anti-avoidance measures in tax treaties
  - Limitation on Benefits
  - Beneficial ownership
- Anti-avoidance rules in domestic tax law
  - SAAR
  - GAAR
  - CFC
  - Thin Capitalization
- BEPs – a paradigm shift in international thinking

Concept

- Treaty shopping is routing of income arising in one country to a person in another country through an intermediary country to obtain tax advantage of tax treaties
- Anti-Treaty Shopping Measures deny tax treaty benefits to non-residents if:
    - It is not the beneficial owner of income
    - Its shareholders are not entitled to treaty benefits
    - The use of intermediate company does not have economic / important reasons
    - It does not carry on business
- Tax Treaty Benefits not to be denied in cases where:
    - Business reasons drive structure
    - Substantive Activities carried on
    - Companies quoted on Stock Exchanges
    - Tax not avoided – Country of Residence collects what Country of Source gives up

Agenda

- Treaty shopping - Concept
- **Key anti-avoidance measures in tax treaties**
    - **Limitation on Benefits**
    - **Beneficial ownership**
- Anti-avoidance rules in domestic tax law
    - SAAR
    - GAAR
    - CFC
    - Thin Capitalization
- BEPs – a paradigm shift in international thinking

LOB Article

- LOB article in the treaty limits treaty benefits to treaty country residents with sufficient 'nexus' to treaty countries
- Several 'safe harbour' tests are set out, which if met will result in treaty benefit
  - Residential status of Shareholders / Listing Criteria
  - Active Trade
  - Minimum expenditure requirement
  - Requirement that the entity is regulated, to be considered resident
- A discretionary relief provisions creates a last resort mechanism to obtain treaty benefits
- Standard LOB Article is found in Article 22 of US Model Convention

LOB Article

- Most of India's earlier treaties (with notable exception of US) did not have LOB provisions
- In 2005 & 2008, India negotiated LOB provisions through protocols to the Singapore & UAE treaties
- Post this, most of India's treaties now have a LOB clause (Nepal, Malta, UK, Malaysia, Poland, Ethiopia) – Affair arranged with the main or one of the main purposes to claim treaty benefits
- However, consistency in India's policy towards LOB is still evolving
  - LOB in Ethiopia, Nepal and other recent treaties allows application of domestic GAAR provisions

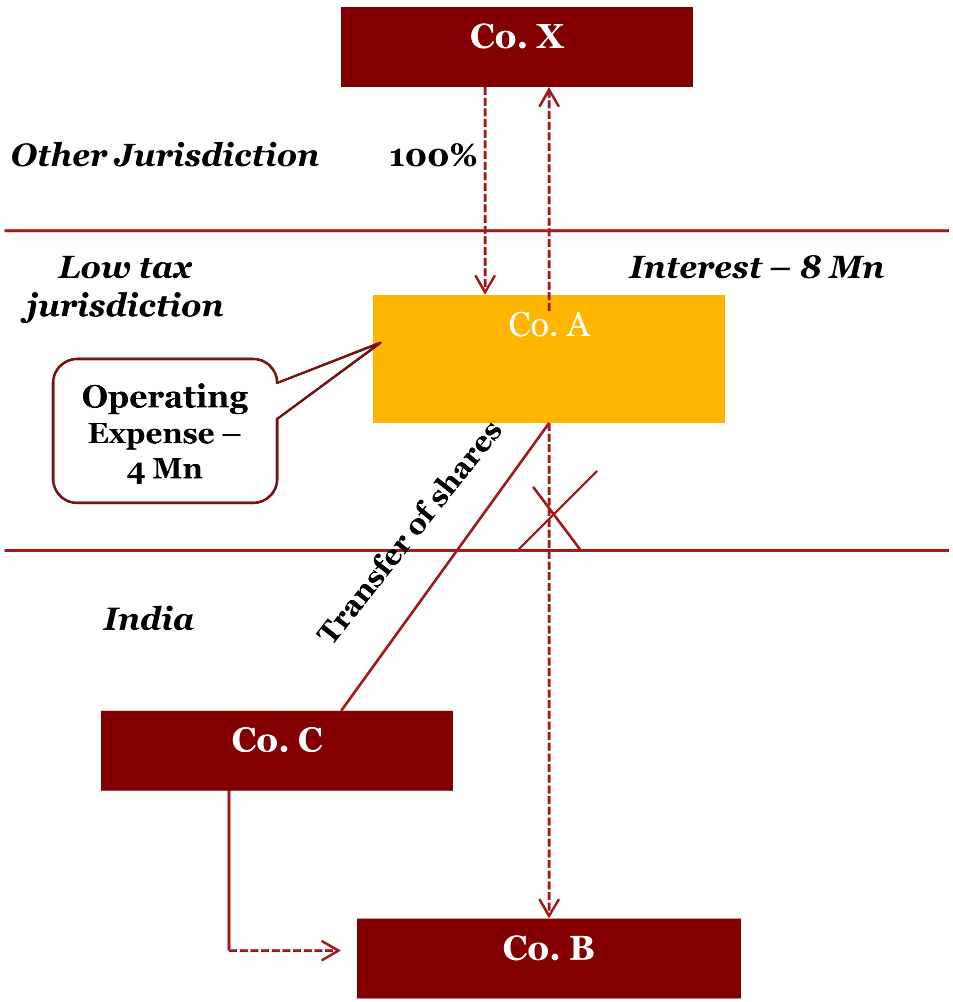
LOB Article

- India - US LOB (Article 24)
  - ownership & base erosion test; or
  - Active Business test & derived in connection with/or incidental to; or
  - stock exchange listing test; or
  - competent authority is the last resort

LOB Article

- India - Singapore LOB (Protocol)
  - Intention test (affairs arranged with primary purpose to take treaty benefit)
  - Shell/conduit company test - negligible or nil business operations or with no real and continuous business activities;
    - Companies with an expenditure (operating or non-operating unspecified) below a certain threshold are deemed shell companies. Further, listed entities and companies meeting the expenditure required are deemed not to be shell companies
  - Additionally, Article 24 (limitation on relief) requires the income to be received or remitted in Singapore, for such income to enjoy treaty benefits (and which is subject to Singapore tax by reference to amount received or remitted in Singapore

LOB Article - Illustration



Facts

- Co. X having investment objective to invest in India
- Co. X invests in India through Co. A, its wholly owned subsidiary
- Subsequently, Co. A sells shares of Co. B to Co. C
- Co. A claims capital gains exemption under tax treaty
- Argument of complying with annual expenditure requirement of INR 10 Mn

Analysis

- Only INR 4 Mn of operating expense
- Balance paid as interest to Co. X outside residence country
- Not considered to meet prescribed conditions under applicable tax treaty
- Co. A deemed to be shell/conduit Co. – Anti Avoidance provisions to be invoked

Beneficial owner

- Critical condition for availing benefit of a tax treaty in case of income by way of interest, dividends, royalties and fees for technical services. Arms' length criteria also incorporated in treaties for such income
- A term not defined in tax treaties – ongoing debate on whether domestic tax law or international tax language applies
- According to Klaus Vogel : Beneficial Owner is a person who is free to decide
  - Whether or not the capital / assets should be used / made available for use by others
  - How the yields from them should be used
- US MC regards beneficial owner as a person if the income is attributable to him for tax purposes as a resident
- Non satisfaction of this criteria could lead to denial of treaty benefits

Beneficial owner

- The ‘beneficial owner’ of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received -OECD Commentaries and in the Conduit Companies Report
- Prevost, a decision by the Canadian FCA signals a ‘Form based approach’ over ‘substance over form’ and respect for legal relationships
- Velcro, a 2012 decision by the Tax Court of Canada held that the recipient of royalties under a sub-license was the beneficial owner, nothwithstanding its obligation to pay royalties to the primary licensor since it had ‘possession’, ‘use’, ‘control’ and ‘risk’ in respect of royalties
- Circulars by China and Egypt seek to provide administrative guidance on beneficial ownership; this trend is likely to create conflict with treaties and their interpretation
- Recent protocol to India-UK treaty deletes the existing dividend article and the new dividend article has inserted a more broader anti-abuse provision
- India-Australia treaty requires ‘beneficial entitlement’ which is concerned with ‘right to use and enjoy’ rather than ownership

Agenda

- Treaty shopping - Concept
- Key anti-avoidance measures in tax treaties
  - Limitation on Benefits
  - Beneficial ownership
- **Anti-avoidance rules in domestic tax law**
  - **SAAR**
  - **GAAR**
  - **CFC**
  - **Thin Capitalization**
- BEPs – a paradigm shift in international thinking

SAAR in domestic tax laws (some examples)

- International Transfer pricing
- Domestic transfer pricing
  - Harmonization of ‘related party’ definitions
  - Avoid conflict between domestic and international transactions
  - Guidance on how to ‘benchmark’ Director’s remuneration
  - Arm’s length price v/s ordinary profits
  - Correlative adjustments
- Section 94A
  - Discourage transactions with persons located in any country or jurisdiction which does not effectively exchange information with India (Cyprus)
  - Transfer pricing provisions to apply
  - Potential taxation/Disallowance of expenditure/Higher withholding

SAAR in domestic tax laws (some examples)

- Section 9 (Amended vide Finance Act 2012)
  - Clarificatory amendment made with intention to overrule Vodafone judgment. Transaction between two non resident companies in relation to transfer of shares of an overseas company which substantially derives value from assets located in India is taxable.
  - Amendment retrospective from 1962
- Section 56(2)(viia) (Introduced vide Finance Act 2010)
  - A firm/ closely held company receiving shares of a closely held company without consideration or for inadequate consideration - the aggregate FMV taxable less consideration for the transfer taxable as ‘Income from Other sources’
  - AAR rulings in Dana Corporation and Amiantit overruled
- Section 50D (Introduced vide Finance Act 2012)
  - FMV of asset shall be deemed to be the full value of consideration if actual consideration is not attributable or determinable.
  - Rulings in Dana Corporation, Goodyear and Bharat Bijilee overruled

GAAR

- GAAR provisions are incorporated in the Income-tax Act, 1961 to be effective from April 1, 2016 (Financial Year 2015-16).
- Arrangement should have been entered into with the main purpose of obtaining tax benefit
- Along with tax benefit test, the arrangement should also satisfy at least one of the following tests:
  - Abnormal rights and obligation tests
  - Misuse or Abuse test
  - Commercial Substance test
  - Bona fide
- Consequences of Impermissible Avoidance Arrangement:
  - Equity may be treated as debt and vice versa
  - Capital accruals or receipts may be treated as revenue and vice versa
  - Any expenditure, deduction, relief or rebate may be recharacterised

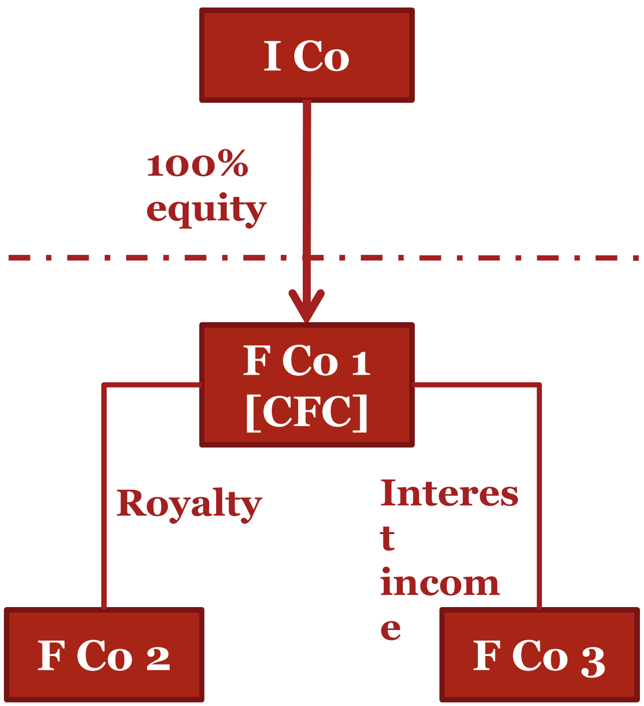
GAAR

- Key aspects clarified by the recently notified GAAR Rules (September 2013)
  - Applies where the tax benefit (to all the parties in aggregate) in a year exceeds INR 30 million
  - FIIs excluded if they do not avail of benefits under a Tax Treaty
  - Investments in FIIs (such as Participatory Notes), directly or indirectly, are excluded
  - Grandfathering provisions (though some ambiguity exists)
    - Income arising after April 1, 2015 from transfer of investments made prior to August 30, 2010 would be grandfathered
    - Applies in case of other arrangements such as involving payment of interest, royalty, etc., after April 1, 2015, even if those arrangements were made prior to August 30, 2010
  - Where only a part of an arrangement is declared to be an impermissible, the consequences apply to such part only (and not the entire arrangement).

CFC Rules

- Under the proposed CFC rules/ provisions, any passive undistributed income earned by a foreign company which is controlled directly or indirectly by a resident in India shall be deemed to have been distributed and consequently, would be taxable in India in the hands of resident shareholders as dividend received from the foreign company
- Under the DTC, a CFC is a foreign company that satisfies the following conditions:
  - For the purposes of tax, it is a tax resident of a territory with a lower rate of taxation
  - Its shares are not traded on a stock exchange of such territory
  - One or more Indian residents, individually or collectively, exercise control over it
  - Is not engaged in active trade or business
  - Its specified income (computed as prescribed) exceeds INR 2,500,000
- The rules seek to tax undistributed income of a CFC under the head 'income from residuary sources'. Any income that has already been taxed under the CFC rules, will not be again taxed on actual receipt
- Under the rules, a resident is required to furnish prescribed details of investment and interest in any entity outside India.

CFC Rules - Illustration



Assumed scenario:

- **F Co 1 is a CFC**
- **F Co 1 owns IP & also acts as funding vehicle**
- **F Co 1 earns royalty from F Co 2 and interest from F Co 3, both of which are 'passive incomes'**
- **F Co 1's passive income is taxable in hands of I Co as deemed dividend income**

Thin capitalization rules

- Thin capitalization rules seek to limit deduction available to a person on interest paid to any other person for an excessive proportion of 'in-house' debt
- As per 1987 OECD Report, 'thin capitalization' is commonly used to describe 'hidden equity capitalization' through excessive loans
- Illustratively, categories of loans that could be considered as Debt:
  - Ordinary loans (including non-interest bearing loan);
  - Back to Back loans through banks;
  - Loans from third parties based on guarantees issued by a related party;
  - Profit participating loans generally treated as equity
- Debt financing is often, but not always more favorable in case of cross border investments (eg India where dividends received are tax exempt)
- Judicial precedents have held that in absence of 'thin capitalization rules', interest paid to shareholders for loans cannot be disallowed despite capital-structure tax-planning

Agenda

- Treaty shopping - Concept
- Key anti-avoidance measures in tax treaties
  - Limitation on Benefits
  - Beneficial ownership
- Anti-avoidance rules in domestic tax law
  - SAAR
  - GAAR
  - CFC
  - Thin Capitalization
- **BEPs – a paradigm shift in international thinking**

BEPs – a basic introduction

Why focus on BEPS?

- Deficits

- Climate of austerity and renewed focus on the contribution from business

- Politicians and the media

What is the goal of BEPS?

- Focus on double non-taxation (or less than single taxation) through “cracks” in the interaction of domestic tax systems

- Primary aim is to address situations where profits are perceived as geographically divorced from activities

The OECD's work on BEPS

Timeline

2012	- project announced / started
2013	- Release of document, "Addressing Base Erosion and Profit Shifting" (February)
	- Release of Action Plan (July) with 15 separate actions / work streams
2014	- Completion of approximately ⅓ of Action Plan (September)
2015	- Projected Completion of remainder of Action Plan (September / December
2016 and forward	- Monitoring, additional / on-going actions

Thank You