INDIA AND THE BILATERAL TAX TREATIES: A LEGAL STUDY

Dissertation submitted to the Jawaharlal Nehru University in partial fulfillment of the requirement for the award of the degree of

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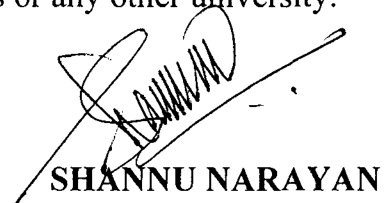

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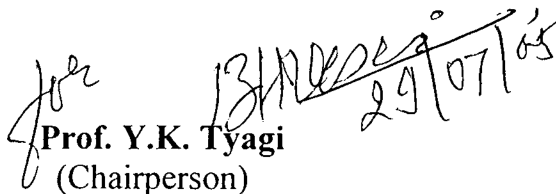

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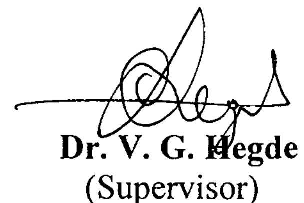

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List of Acronyms

AAR - Authority for Advance Ruling

AP - Andhra Pradesh

ASEAN - Association of South East Asian Nations

BIPA - Bilateral Investment Promotion Agreement

BIT - Bilateral Investment Treaty

BTTs - Bilateral Tax Treaties

CERDS - Charter of Economic Rights and Duties of States

C. I. T. - Commissioner of Income Tax

DTAA - Double Taxation Avoidance Agreement

DTAC - Double Taxation Avoidance Convention

FERA - Foreign Exchange Regulation Act

FII - Foreign Institutional Investors

GATS - General Agreement on Trade in Services

GATT - General Agreement on Trade and Tariff

ITR - Income Tax Reporter

MFN - Most Favoured Nation

MNEs - Multinational Enterprises

MRTP - Monopolies and Restrictive Trade Practices

MTC - Model Tax Convention

NIEO - New International Economic Order

NIP - New Industrial Policy

OECD - Organisation for Economic Cooperation and Development

SAARC - South Asian Association for Regional Cooperation

SC - Supreme Court

TNCs - Transnational Corporations

UN - United Nations

UNCTAD - United Nations Center for Trade and Development

WTO - World Trade Organisation

Dedicated to
my
Beloved Parents & Respected Teachers

Chapter I

Introduction

CHAPTER I
INTRODUCTION

1.1. Overview

Economic development[1] is one of the fundamental objectives of every country, especially developing countries.[2] Foreign investment was considered as a good method to attain the developmental goals.[3] By promoting foreign investment a country allows itself to receive new technology, capital and obtain flow of goods etc. Therefore various international agreements were entered into to facilitate these objectives. In this regard, the principal actors of foreign investments are the home country, the host country and the foreign investor.[4]

One of the primary issues arising due to increased Foreign Direct Investment (hereafter referred to as FDI) flow is on the taxation of the foreign investors. Taxing them becomes problematic, because both the home country and host country has the jurisdiction to exercise their right to tax the income of these investors based on either their residence or income accruing to the

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[1]Article 3, paragraph 3, of the 1986 UN Declaration on the Right to Development, General Assembly A/RES/41/128, 4 December 1986, emphasis that 'States have the duty to cooperate with each other in ensuring development and eliminating obstacles to development...and fulfil their duties in such a manner as to promote a new international economic order based on sovereign equality, interdependence, mutual interest'.
The post war period can be traced back as the concern for development by the newly independent states. The decolonization process after World War II with transformed social and political climate then existing generated two basic legal concepts; (i) international law of development, and (ii) right to development (with special reference to economic self-determination). See F. V. Garcia-Amador, *The Changing Law of International Claims* (Oceana Publications, Inc., 1984), Vol. II, at p. 617.

[2] UNCTAD, *World Investment Report 1998: Trends and Determinants* (New York and Geneva: United Nations Publications), Sales No. E.98.II.D.5, Ch. III, Investment Policy Issues, B. Double Taxation Treaties, paragraph 3, p.76;

[3]See M. Sornarajah., *The International Law of Foreign Investment* (Cambridge: Cambridge University Press), 1999; Fiona Beveridge, *The Treatment and Taxation of Foreign Investment under International Law*, (Juris Publishing, Manchester University Press, 2000).

[4] UNCTAD, n. 2, at p.75. Home country means the country in which the foreign investor resides or the country to which the foreign investor belongs through residence, place of control and effective

state. Both under international law and national law taxation of foreign investor has always been an issue, especially when dealing with the avoidance of double taxation of the same person on the same income for the same period. Under International law, this problem has been addressed by encouraging the countries to enter into Bilateral Tax Treaties (hereafter referred to as BTTs) based upon either of the two framework model tax conventions, namely;

i) The Model Tax Convention on Income and on Capital (Organization for Economic Cooperation and Development, 1963)[5] (hereafter referred to as OECD MTC) or

ii) United Nations Model Double Taxation Convention between Developed and Developing Countries, 1980,[6] (hereafter referred to as UN MTC)

In this regard, it becomes inevitable to define the term 'Double Taxation.' It means "imposition of comparable taxes by two or more sovereign countries on the same item on income of the same taxpayer for the same tax period." The issues on avoidance of double taxation and prevention of fiscal evasion are remedied by BTTs entered into by the Contracting States that specifies as to which income should be taxed and in which state, i.e., by home country or the host country. In order to understand the inconvenience caused by the process of double taxation, it becomes essential to analyse the tax treaties which deals with the concept of double taxation avoidance and also to study how it has affected the Contracting States, be it developed or developing.

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management. Host country is defined as that country in which the foreign investor invests and a foreign investor would include both individuals and companies too.

[5]UNCTAD, *International Investment Instruments: A Compendium,* Vol. II, Regional Instruments, United Nations (New York and Geneva, 1996), United Nations Publication Sales No. E.96. II.A.10, pp. 71-88.

[6]UN Document ST/ESA/102, Sales No. E.80. XVI.3 (New York: United Nations); see also UNCTAD, *International Investment Instruments: A Compendium,* vol. 1, Multilateral Instruments, United Nations (New York and Geneva, 1996) United Nations Publication Sales No. E.96.II.A.9, pp. 109-131.

1. 1. 1. Evolution of Tax Treaties under International Law

On tracing the historical evolution of the tax treaties one can find that the first agreement ever made to deal with tax matters was the France-Belgium Agreement, 1843 (on mutual assistance) and the first Bilateral Treaty, which is of more legal significance, was between Prussia and Hungary, signed in 1899.[7] There have been various attempts to form a multilateral MTC prior to the Charter period and later too. For the sake of convenience we shall categorise the evolution period into two, i.e., during, (i) the League of Nations; and (ii) the United Nations.

In 1920, after the International Financial Conference, a recommendation was made to the League of Nations (hereafter referred as the League) to consider the question of avoidance of double taxation. In the meantime, International Chamber of Commerce (ICC) sought the help of the League to overcome the issue of international double taxation. In 1921, the Finance Committee of the League was entrusted to study the economic aspects of international double taxation. During the International Economic Conference, in 1922, a recommendation was made to deal with the issue of fiscal evasion. Later, a group of high officials from seven European Countries were appointed to deal with the fiscal administration. In 1925, League's Financial Committee submitted four model bilateral conventions.[8] The first draft model on the same was concluded in Geneva in 1928. The said Committee organized meetings in Mexico during 1945 and proposed minor corrections in the draft models.

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[7] UNCTAD, (1999), *International Taxation.* UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations), United Nations Publications, Sales No. E. 99. 11. D. at p. 22.

[8] Report presented to the Financial Committee of the League of Nations by the Committee of Technical Experts on Double Taxation and Tax Evasion, L. N. Doc. No. C. 216. M. 85., 5 (1927) as cited in Oscar M. Trelles, II, "Double Taxation/Fiscal Evasion and International Tax Treaties," *Indiana Law Review,* vol. 12, no. 2, 1979, 341 – 378, at pp. 343. the four model bilateral conventions are (i) elimination of double income taxation, (ii) elimination to double succession duties, (iii) exchange of information, and (iv) reciprocal assistance and collection of taxes.

The Economic and Social Council of the UN published a model convention in Geneva in 1946. Model tax treaties drafted by the League were known as "Model Treaty of Mexico, 1943" and "London Model Treaty, 1946." These drafts were prepared by the Organization of European Economic Cooperation, (OEEC). All these model drafts inclusive of the drafts in the pre charter period aided in bringing uniformity to the bilateral conventions executed in the post war period. Even though, there were still differences in the provisions of the treaty and this resulted in considerable uncertainty for the foreign investor taxpayers. Such discrepancies lead to the formation of Fiscal Committee under the auspices of OEEC, the predecessor of the OECD. The Committee adopted a single multilateral convention in 1963, known as the Model Tax Convention on Avoidance of Double Taxation, 1963. This draft model was later revised in 1977 as the Model Tax Convention on Income and on Capital, (OECD), 1977 and was supplemented by Commentaries to it.

In 1967, the Economic and Social Council of the United Nations (ECOSOC) put forth the need to have a model tax treaty between developed and developing countries. An *ad hoc* group of experts known as United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries was constituted.[9] The Expert Committee comprised of members from both developed and developing countries. The efforts of the Committee lead to the drafting of the United Nations Model Double Taxation Convention in 1980 along with a "Manual for the Negotiations of Bilateral Tax Treaties." Apart from focusing on double taxation issues, these treaties contained articles to eliminate discriminatory tax provisions in internal laws and to reduce international tax avoidance through exchange of information between national tax administrations.[10]

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[9] E.S.C. Res. 1273, 43 U.N.ESCOR, Supp. (No. 1) 5, U. N. Doc. E/4429 (1967). The UN ECOSOC under the resolution authorized the Secretary – General to establish the U. N. Group.

[10] See Stanley. S. Surrey, "UN Group of Experts and The Guidelines for Tax Treaties Between Developed and Developing Countries", *Harvard International Law Journal*, vol. 19, no. 1, 1978, p. 1-71, at pp. 5.

A study of the historical evolution of these treaties show that one of the reasons for the emergence of these MTCs was to assure certainty to foreign investors regarding tax matters, investing in developing countries and trading with them which in turn aided the host country to generate revenue.

1. 1. 2. The Need for Bilateral Tax Treaties

A BTT is entered into in the common interest of all countries for the development of commerce and also to minimise the scope for tax evasion and facilitate the recovery of tax dues. The freedom of choice in tax policies is limited to the countries interested in participating in the exchange of goods, services and technical know-how. The primary purpose of a Double Taxation Avoidance Convention (DTAC or BTT), as defined by the UN Group of Experts in 1979 in its Manual is thus;

> "The growth of the investment flows from the developed to developing countries depends to a large extent on what has been referred to as the international investment climate. The prevention or elimination of international double taxation constitutes a significant component of such a climate."[11]

International juridical double taxation as defined in the Introduction to the OECD MTC, means:

> "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. Its harmful effects on the exchange of goods and services and movements of capital and technology and goods, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries."[12]

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[11] "Manual for the negotiations of Bilateral Tax Treaties." Partnership Report, paragraph.1.

[12] See Phillip Baker., *Double Taxation Conventions – A Manual on the OECD Model Tax Convention on Income and on Capital* (London: Sweet and Maxwell, 2001). The UNCTAD has also listed the purposes of double taxation conventions which are:

- States its objectives of resolving its tax problems between contracting parties and determines its scope of application with regard to its juridical or physical person (*ratione persone*) and taxes *ratione materie.*
- Sets out detailed allocation rules for different categories of income, e.g., income from real property, taxable without restriction in the source country., and interest income, subject to limited taxation in the source country,

Over the years, there has been a paradigm shift in the trend in investment by companies from developed countries towards the developing countries and also among the developing countries *inter se*. This shift could be easily understood by the existence of BTTs between the latter.[13] Generation of foreign investment in the territory of a state is made possible not only by the BTTs but also by the Bilateral Investment Treaties (hereafter referred as BITs) with certain differences. International Investment Agreements were concluded in order to 'secure a stable, predictable and transparent investment climate; increasing the quality and quantity of FDI flows; strengthening domestic entrepreneurship; and recognizing the non-discriminatory exercise of governmental regulatory power in pursuing developmental objectives.'[14] Therefore, Bilateral Investment Promotion Agreements (hereafter referred to as BIPAs) and BITs were entered into to serve this purpose. Both the BITs and BTTs have a similarity in them, in terms of promotion of foreign investment. They both are complementary in nature when it comes to generation of revenue through foreign investment. The general exclusion of taxation matters in the BITs reveal that every state has a right to maintain maximum fiscal sovereignty and also such an exception allows a country to conclude a tax treaty granting special treatment to investment from another country in return for any tax concession.

- Establishes the Arm's Length principle[12] as the standard for the adjustment of transfer prices by tax authorities in the case of transaction between associated enterprises,
- Contains rules giving exemption from tax or credit for foreign tax in the residence country, where income is taxable in the source country
- Contains rules on non-discrimination, mutual assistance, and the exchange of information,
- Establishes procedures for mutual agreement between tax authorities to avoid double taxation in cases of dispute; and
- Occasionally, contains provisions on assistance in the collection of taxes.

UNCTAD, *World Investment Report 1998,* Ch. III, Investment Policy Issues, B. Double Taxation Treaties, para. (8).

[13] This is evident from the 1998, UNCTAD Report, wherein it is stated that around 1,844 Double Tax Treaties covering 182 countries and territories were entered into in comparison to 1,726 Bilateral Investment Treaties entered into by states.

[14]UNCTAD, n. 2, at p. 75.

The dual nature of the BTTs depict their importance because on the one hand they are considered as international agreements entered into between states under which these states agree to limit their fiscal jurisdiction and on the other hand, they become domestic law of the Contracting States as soon as they are concluded.[15]

1. 1. 3. Basic Principles of Taxation

The two primary issues with respect to taxation regimes are to (i) define and describe the tax base (jurisdiction to tax), and (ii) allocate the taxable income or wealth between tax authorities methods of elimination of double taxation). These are the two basic principles of taxation. On the jurisdictional aspects, two states have the right to tax the income, namely; *residence country* (home country in terms of foreign investment) and *source country* (host country). Residence country means the country where the person liable to be taxed fiscally and physically resides and source country is one in which the site of economic activity takes place. Thus, the jurisdictional issues are solved through negotiation process between the countries when they enter into BTT. On methods of elimination of double taxation, there are two methods like, *tax exemption method* and *tax credit method,* followed recently by a new method known as *tax sparing method.*[16]

[15] See Baker, n. 9, at E-20. A Model Tax Convention or a bilateral tax treaty has a dual nature, (i) as an international agreement entered between two states and (ii) as a domestic tax law as and when they are agreed upon. Article 31 to 33 of the Vienna Convention on the Law Of Treaties, 1969, deals with the interpretation of treaties. Article 31 paragraph 1 of the Vienna Convention On the Law of Treaties, requires a treaty to be interpreted in 'good faith.' It is a well-settled law that a bilateral treaty is concluded only through thorough negotiations by each Contracting States and therefore, they are to be followed in good faith.

[16] For details see Chapter II.

1. 1. 4. India and the Bilateral Tax Treaties

India has signed[17] eighty-five BTTs till 2004, inclusive of seventy Comprehensive Tax Agreements and fifteen Limited Tax Agreements. As mentioned earlier, there is a slight difference in the formation of a treaty depending on the economic status of the other Contracting State. In India, we follow credit method of elimination of double taxation, which means, that the income on which a taxpayer has already paid tax in other treaty country shall be deductible to that extent. Tax credit method states that the 'Residence State' would give the taxpayer the credit against his or her tax bill for taxes already paid in 'Source State.' In addition, if a taxpayer has already been taxed in the source country he shall be exempted from tax in 'residence country' up to that amount. Most of the Indian BTTs contain this method of elimination of double taxation.[18]

Under the domestic law of India, a general law like Indian Income Tax Act, 1961, becomes subsided when a BTT is applied for interpretation to uphold the obligations of a state in its bilateral economic relations.

1. 1. 5. Foreign Investments and its Significance on Tax Treaties.

A stable, transparent and certainty of the treatment in the tax system is an important factor for attracting FDI. By entering into BTTs one nation agrees to

[17]Chapter IX of The Income Tax Act, 1961 deals with double taxation relief granted to taxpayers. Section 90 of the Act read with Section 91 gives the benefit of relief from double taxation. The pivotal role played by the collaboration agreements cannot be negated because it emphasises on the application of tax laws of both the contracting states to avoid disputes. Section 90 Of the Income Tax Act, 1961, reads thus;

1. "For granting relief in respect of income on which income tax has been paid under the Income Tax Act both in India & the foreign country.
2. For avoidance of double taxation of income under the Income Tax Act in India & under corresponding law in force in that foreign country.
3. For exchange of information for the prevention of evasion or avoidance of income tax chargeable under the Income Tax Act in India or under corresponding law in tat country

For the recovery of income tax under the Income Tax Act in India and under the corresponding law in force in that country."

[18] For example, Art.23 of the Indo-Mauritius Agreement states that once a person/company has paid tax in Mauritius for income accruing in India and if that person/company is not a "resident" of India, then such tax payer shall not be taxed again.

avoid double taxation disputes through mutual agreement procedure and adopts an internationally accepted approach in dealing with transfer pricing methods.[19]

1. 1. 6. Recent trends with respect to avoidance of double taxation

In 2000, the OECD came out with a detailed report on the harmful tax competition. The operation of "tax havens"[20] and "preferential tax regimes" which are considered as *harm*, in the context of emerging globalization and liberalization lead the way to the increase in opportunity to evade or avoid tax.

The OECD report defines the harmful preferential elements as those with no or low effective tax rates, 'ring-fencing'[21] of domestic and off shore regimes, lack of transparency and lack of effective exchange of information in relation to tax matters. So far thirty-five jurisdictions have been considered as tax havens, which included Mauritius too. There have been various arguments on the relevance of the OECD's reports,[22] as it emphasizes that certain countries are harmful and that the member countries of the OECD would trade only if these countries make their tax laws compatible with their recommendations.

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[19] See *Encyclopedia of Public International Law* defining transfer pricing as "exchange of goods and services between the members of the MNEs is transacted by transfer prices, i.e., intra-group prices which do not necessarily result from the free play of market forces but are determined by the economic policy of the management of the group. Using this means, a group may measure prices so that profits accrue in the country where they are taxed at the lowest rates." See *Encyclopedia of Public International Law*, vol. 4, Max Planck Institute, Heidelberg, Q-Z. p.769-770.

[20] Defining 'tax haven' through 4 characteristics, means that countries; which have no/only nominal taxes, that lack effective exchange of information,' which lack transparency and Firms registered in these tax havens tend to have no substantial activity in the jurisdiction. Council Recommendations and Guidelines for Dealing with Harmful Tax Practices OECD C (98) 17 (OECD, 1998). Akiko Hishikawa, "The Death of Tax Havens?", *Boston College International and Comparative Law Review*, vol. 25, n. 373, p. 389-417.

[21] It is where a "jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy".See, the OECD Report 2000.

[22] These arguments have been dealt in detail in Chapter II, under sub section 2. 6. 3. on *Compatibility between OECD and WTO on double taxation.*

1.2. Review of Literature

The proposed study on this subject involves a review of the works of the scholars who have given different approaches and viewpoints to the concept of double taxation avoidance in the light of both multilateral tax treaties and BTTs. There are literatures available on the psychology of justice and tax compliance and how the concept of tax relief evolved (Valerie Braithwaite, 2003).[23] One of the basic literature for the interpretation and application of tax treaties was discussed by (James Simons, 2002),[24] wherein he deals with the aspects of development of taxation, tax theory and the principles, taxation and political processes, legal consequences, and theories on avoidance of double taxation in relation to tax evasion and avoidance.

There are few scholarships available on the close nexus between foreign investment and taxation, and also on taxation of foreign investment. It also envisages the weaknesses of traditional approaches to taxation of foreign investments. Fiona C. Beveridge[25] has analysed the concept of taxation under international law apart from the issue of its relevance, the jurisdictional aspect and then giving the provisions in various important international law documents. The author makes reference to the challenges to international law due to the changing nature of the concept of free trade aspect after the globalization. Further, the book also deals with relationship between regional free trade agents and taxation problems.

On foreign investment there are lots of literatures available, arguing for and against the need for foreign investment. On the importance of the same there are

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[23] Valerie Braithwaite, *Taxing Democracy: Understanding Tax Avoidance and Evasion* (England: Ashgate Publishing Ltd., 2003).

[24] Simon James, *Taxation: Critical Perspectives on the Third World Economy,* (London: Routledge, 2002).

[25] Fiona C. Beveridge, *The Treatment and Taxation of Foreign Investment under International Law* (New York: Juris Publishing, Manchester University Press, 2000).

few literatures available by scholars like Sornarajah, 2002;[26] Nico Schrijver, 1997;[27] Kenneth Vandevelde, 1998.[28] Vandevelde in his article stresses on the theoretical aspects and also defines why foreign investment is essential. He argues that for a developing country, liberal economic theory should be the best to *lure foreign investment* for economic growth. He further justifies how the concerns of developing states for the negotiation of a Bilateral Investment Treaty were influenced by Marxist ideologies. Most of the foreign investment promotion agreements like the BIPAs and BITs exclude taxation from within the ambit of these treaties.

The scholars like Phillip Baker[29] and Klause Vogel[30] gives out the importance of these MTCs and justifies why they are used as an aid to interpretation of the MTCs. Phillip Baker has dealt elaborately with the OECD MTC and its Commentaries and it serves as an aid to interpretation whenever there is a dispute on the application of the treaty. A third world perspective is depicted in the scholarly work by M. B. Rao,[31] wherein he brings out the study of the UN MTC beginning from the negotiations in order to emphasize the position of the

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[26] M. Sornarajah, *The International Law of Foreign Investment* (Cambridge: Cambridge University Press), 1999; see also M. Sornarajah, "State Responsibility and The Bilateral Investment Treaties," *Journal of World Trade Law,* vol.20, 1989, p. 79.

[27] Nico Schrijver, *Sovereignty Over Natural Resources: Balancing Rights over Duties*, 1997; Daniel D. Bradlow, and Alfred Escher, ed., *Legal Aspects of Foreign Direct Investment* (The Hague: Kluwer Law International, 1999).

[28] Kenneth. J. Vandevelde, "The Political Economy of Bilateral Investment Treaties," *American Journal of International Law*, vol. 92, 1998, p. 627; see Vandevelde, "Investment Liberalization and economic development: The Role of Bilateral Investment Treaties," *Columbia Journal of Transnational Law*, vol. 36, 1998, p. 501-516.

[29] Philip Baker, *Double Taxation Conventions – A Manual on the OECD Model Tax Convention on Income and on Capital* (London: Sweet and Maxwell, 2001).

[30] Klause Vogel, *Double Taxation Conventions* (Kluwer Law International: 1997).

[31] M. B. Rao, *Taxation of Foreign Income: India Double Taxation Treaties* (New Delhi : Vikas Publishing Home Pvt. Ltd., 1997).

developing countries. The study also gives a complete idea of the Indian position and analyses few of the early BTTs signed by India.

A plethora of literatures are available on the study Indian BTTs by Indian authors (Santhanam, 2004;[32] Agarwal, 2001;[33] D. P. Mittal,[34] etc.,). They have dealt with the importance of BTTs, the implementation of these tax treaties in India through existing provisions under the Indian Income Tax Act, 1961 and issues relating to double taxation relief which emerged out of the cases laws in the Indian courts. Most of the recent literature available and written by Indian authors deals with the Indo-Mauritius issue in detail.

Authors like Noshir M. Lam ((et al.,), 2002);[35] have discussed how Mauritius had become a tax haven and later they remedied the discrepancies in their tax laws by enacting subsequent legislations to it, considering the significance of India's bilateral relation with Mauritius.

There have been discussions for forming a uniform multilateral tax treaty under one international institution to regulate and decide tax matters especially, with respect to avoidance of double taxation based on the OECD MTC. Victor Thuronyi argues for such a tax treaty under one international tax organization, in order to apply uniform laws throughout the world.[36] There has objections raised by many scholars, especially Richard J. Vann,[37] against the formation of a multilateral tax treaty based on OECD MTC stating that it is not an appropriate model to be followed. He

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[32] R. Santhanam, *Handbook on Double Taxation Avoidance Agreement Tax Planning For Collaborations*, (New Delhi: Commercial Law Publishers (India) Pvt. Ltd, , 2004).

[33] H. P.Agarwal, *Business Collaboration With India along with Texts of Double Taxation Treaties*, (New Delhi: Wadhwa and Co., 2001), 6th edn.

[34] D. P. Mittal, *Indian Double Taxation Agreements and Tax Laws*, (New Delhi: Taxmann Allied Services Pvt. Ltd., 2001).

[35] Noshir M. Lam, Mayur Nayak and Mittil Chokshi, *Mauritius: International Business and Tax Strategies*, edn.1 (Snow White, 2002).

[36] Victor Thuronyi, "International Tax Cooperation and a Multilateral Treaty", *Brooklyn Journal of International Law*, vol. 26, no: 4, 2001, p.1641-1697.

further advocates that the equality principle as deemed to be enshrined in the BTTs never exists since whenever a country which has more bargaining power negotiates with other countries there would seldom be any equality during negotiations.

There are few literatures available on the relationship between international tax law and international trade law, which emphasizes on the changes that has come into effect in taxation matters after the establishment of the WTO regime.[38] Few scholars[39] have traced how trade and tax is related and also as to whether there is any provision in the WTO Agreements which deal with the avoidance of double taxation, accentuating on the evolution of certain principles in the light of the decisions of the GATT Panel. However there has been no focused study on the aspects of double taxation avoidance in India, Indian case laws and the impact of the WTO principles during the negotiations of the Bilateral Tax Treaties entered into by India after its establishment.

I. 3 Significance of the study

The study is significant because any flaws in the tax treaties would affect the bilateral economic relations of the Contracting States and thereby have an adverse impact on international trade. This would affect the economies since whenever a country practices to keep low tax rates on income from foreign investor (which might be compatible with their domestic law) it affects the interests of certain other nations too. One of the major reasons could relate back to the low

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[37] Richard J. Vann, "A Model Tax Treaty for the Asia-Pacific region?" (Part I) *Bulletin for International Fiscal Documentation*, vol. 45, no. 3, 1991, p. 90.

[38] Azzi, John, "Tackling Tax Treaty Tensions: Time To Think About an International Tax Court", *Bulletin of International Fiscal Documentation*, vol.52, no.8/9, 1998, p.344-357; see also Avi-Yonah Reuven, "Treating Tax Issues through Trade Regimes" *Brooklyn Journal of International Law*, Vol. 26. 2001, at p. 1683.

[39] Asif. H. Qureshi, "Trade Related Aspects Of International Taxation: A New WTO Code of Conduct", *Journal of World Trade*, vol. 36, no. 2, 1996, p.16; see also Fischer, Zernin. J., "GATT v/s Tax Treaties? The Basic Conflicts Between International Taxation Methods and the Rules and Concepts of GATT" *Journal of World Trade Law*, vol. 21, no.3, 1987, p.39-61.

tax rates in the tax haven country which enables them to attract foreign investors making other countries at a disadvantageous position leading to loss of revenue for them.

Whenever there is an ambiguity, dispute or any difference of opinion on the interpretation of a provision of a BTT, domestic tax laws of both the Contracting States shall be applied. Though this principle is clear, its application is complicated. India in particular, have several case laws under the BTTs. One of the significant features of the BTTs as mentioned earlier is to promote foreign investment *vis-à-vis* laying down affirmatively the country where the income of the investor would be taxed. In the Indian scenario, when there was an increase in FDI, there emerged the problems of avoidance of 'taxation' by the foreign investors. This is evident from the emerging case laws in India, either on the implementation of the BTTs or interpretation of any provision under the Treaty.

The issues of avoiding tax by the foreign companies became prominent in an important case law, wherein the India-Mauritius Tax Treaty was made subject to the interpretation. The contentions raised were regarding the tax avoidance by the foreign institutional investors in spite of being given special tax concessions to them in India. Even at the international level, the foreign companies adopt various methods to avoid taxation. The common methods of tax avoidance practiced by the companies are:

1) Shifting of profits to low tax countries by transfer pricing.
2) Reducing the tax liability through conversion of income into capital gain.
3) Establishing base companies in Tax Havens, etc. The ongoing practice of companies investing in a tax haven, is detrimental to the economic growth, and hence needs to be checked. This could happen only if there is transparency in dealing and an effective exchange of information by both the contracting states.[40]

[40] This has been dealt in detail in Chapter 3.

In the light of emerging trends of Mauritian Financial Institutional Investors in India (which lead to substantial increase in FDI), and tax avoidance by them in India (during 2003) it still remains as one of the major issues in tax matters.

1. 4. Scope and Objective of the study

The proposed study is on the two aspects: need for bilateral tax treaties and significance of it in maintaining bilateral economic relations with special reference to the salient features of the Indian BTTs. The study attempts to concentrate on the nuances of the agreements, which exist between India and the developed countries and also between India and the developing countries. Further, attempts has also been made to look into the agreements entered into, after the establishment of the WTO in relation to analyse whether there exists any significant change in the definitions in the agreements with the existing agreements.

In the field of taxation, attention has to be focused on the level playing fields for firms with foreign investors, particularly by addressing the double taxation problems, and on the need to restrict the transfer pricing methods adopted by the TNCs in order to avoid tax. Accordingly, the study refers albeit briefly, to the law of foreign investment, state sovereignty, economic self-determination, sovereign equality, and the negotiation process. The issues raised in the study, briefly, are;

(i) Multilateralism versus bilateralism in the context of existing arguments favouring a uniform multilateral tax treaty,

(ii) Concept of economic equality or economic sovereignty and the complexities of BTTs negotiations,

(iii) Globalisation[41] and the changes in the formation of tax treaty,

[41] From the legal point of view, globalisation means that national governments, even in powerful countries, have a decreasing ability to act unilaterally in their internal and external economic affairs. The *OECD Report On Regulatory Reform, Vol. II: The Thematic Studies,* 1997, Chapter 5: International Market openness and Regulatory Reform, at pp. 299-302, as cited in Daniel D.

(iv) India and the tax treaties and its legal status under domestic law.

I. 5. Methodology

The study will be based on the primary and secondary sources available on the subject matter. Primary sources include the UN MTC and OECD MTC, along with the various Reports of the OECD on certain key issues like Harmful Tax Practices, WTO legal texts and relevant case laws decided. Apart from that certain Indian case laws would also be relied on to study the principles evolved by Indian judiciary on this aspect. Further, the study shall rely on the review of books, articles and the *opinio juris.* The study would incorporate an examination of few Indian BTTs in comparison to other international agreements between certain countries which follows the same tax principles.

I. 6. Outline of the Study

The study is divided into five chapters. **Chapter I** would include the evolution of the concept of BTTs and its relationship with foreign investment, basic principles of taxation. This would give a brief description about the recent problems and issues that has occurred at the international level due to the practice of international harmful tax competition and also of the significance of these treaties in India. This chapter would contain an overview of the study

Chapter II would review the two existing MTCs at the multilateral level, which the countries have adopted and also the importance globalisation in changing the concepts in these treaties. It would analyse the impact of the OECD reports which has categorised countries as tax havens and harmful preferential tax regimes. A review of other multilateral approaches to the concept of avoidance of double taxation shall also be dealt, especially under the GATT and

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Bradlow and Alfred Escher ,ed., LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT, (The Hague: Kluwer Law International, 1999), that there is a tension between the traditional concept of state sovereignty and the ability of the nations to independently choose their economic system.

the WTO regime. This chapter would include the debate on Multilateralism versus bilateralism in relation to form a uniform tax treaty at the multilateral level.

In **Chapter III** there would be an attempt to study or deal with the changes that has occurred after the new industrial policy in India and their impact on the tax structure and foreign investment. The relationship between BTTs and Indian domestic laws like India Income Tax Act and Indian Companies Act are mentioned. Salient features of the BTTs would also examined in the light of certain judicial decisions of the Indian courts. Moreover, the overriding effect of the BTTs over domestic laws of India is also considered.

Chapter IV of this study would be an attempt to interpret four BTTs signed by India with Mauritius, Malaysia, United States and United Kingdom. These countries play a significant role because they are the top major foreign investors in India. The study would also attempt to undertake a comparative an analysis of the BTTs signed by India with the SAARC Countries.

Chapter V would give a conclusion to study of the subject in the light of arguments raised in previous chapters of this study draw some suggestions.

Chapter II

Multilateral Framework To Tax Treaties

CHAPTER II

MULTILATERAL FRAMEWORK TO TAX TREATIES

2. 1. Introduction

During the decolonisation period[1] was a period of turbulence for the developing countries, in terms of attaining development both economically and socially. One of the areas of international law, which was influenced by such revolutions, was the field of international economic law.[2] As a matter of enhancing economic relations and encouraging economic developments, foreign investment was promoted.[3] Investing in another country (host country) was a problem unless and until there existed a tax treaty between both home and host country (or rather residence country and source country). As mentioned earlier[4], there were various attempts at the multilateral level to evolve a framework Model Tax Convention (hereafter referred to as MTC) for avoidance of double taxation and prevention of fiscal evasion.

At the multilateral level, attempts have been made to evolve a framework or a MTC. The OECD MTC, 1963 (revised in 1977) is one of the earliest known conventions, followed by the 1980 United Nations MTC. The OECD MTC is followed by the developed countries, whereas the UN MTC is generally followed by many of the developing countries including India.[5] Both

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[1] The post decolonisation period is from the latter part of the 1940s till the decade of the 1970s when many former colonies became independent from colonial rule.

[2] See Peter T. Muchlinski, "Attempts to extend the Accountability of the TNC's: The Role of UNCTAD," in Menno T. Kamminga and Samar Zia Zarifi, LIABILITY OF MULTINATIONAL CORPORATIONS UNDER INTERNATIONAL LAW (Kluwer Law International, 2000).

[3] The concept like economic development has a close linkage with *economic sovereignty* because this concept emerged and found its expression in the widespread reforms embarked on by states. See Fiona Beveridge., *The Treatment and Taxation of Foreign Investment under International Law*, (Juris Publishing, Manchester University Press, 2000) at p. 8.

[4] For details refer back to section 1.1.1 on Evolution of the Tax Treaties under International Law.

[5] See Miranda Stewart, "Global Trajectories of Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries", *Harvard International Law Journal*, vol.44, no.1, 2003, pp.139-90 at p.147; see also Richard J. Vann, *International Aspects of Income Tax* in TAX LAW DESIGN AND DRAFTING (vol.2), Victor Thuronyi, ed., (IMF: 1998), pp.719-80 at p.723

these conventions are widely accepted and adopted while negotiating a BTT, be it between two developed countries or between one developed country and another developing country.[6] It may be pertinent to note, that till 1998, the total number of tax treaties signed, based on either of the above - mentioned MTCs numbered to 1,844 covering different Countries and territories.[7]

In view of their importance and application by many countries, the study would examine the salient features of these MTCs. it would also encompass the significant changes that have been effectuated by the establishment of the WTO regime, which has tried to incorporate certain provisions in consonance with the DTAAs or BTTs. Accordingly the present chapter will be devoted to the study of the main principles incorporated in these conventions.

2. 2. The Model Tax Conventions

The main purpose of the tax treaties,[8] to put it simply, is to avoid double taxation on international transactions and to prevent fiscal evasion.[9] For example, there were three main objectives before the OECD Council of Recommendation while drafting the OECD MTC which *inter alia*, provided for, the elimination of double taxation among member countries for completing the work undertaken to date in the field of "the liberalization of trade, current

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[6] UNCTAD, *World Investment Report 1998: Trends and Determinants* (New York and Geneva: United Nations Publications), Sales No. E.98.II.D.5, Ch. III, Investment Policy Issues, Bilateral Double Taxation Treaties, paragraph 3, p.76; see also, Phillip Baker, *Double Taxation Conventions: A Manual on the OECD MTC on Income and Capital*, (London: Sweet and Maxwell, 2001), p. B-11.

[7] UNCTAD (1999), *International Taxation.* UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations), United Nations Publications, Sales No. E. 99. 11. D.

[8] See Pierre Gravelle, "Tax Treaties: Concepts, Objectives and Types," *Bulletin of International Fiscal Documentation,* Vol. 42, 1988, p. 523, wherein the author states that "while the elimination of double taxation is an objective which is usually stated in its title, in reality a treaty is more correctly described as an instrument which refines and improves existing provisions in the domestic legislation which are designed to accomplish that end...."

[9] The OECD and UN MTC leave the content of the Preamble to be dealt in accordance with the constitutional procedure of the negotiating states; see Stewart, n.5, at p. 147.

invisible operations and movement of capital and manpower;"[10] to establish a draft Convention unanimously accepted by the member countries 'on uniform principles, with uniform definitions, rules and methods and ...in common interpretation;'[11] and to clarify, standardize and guarantee the fiscal situation of taxpayers in each Member country, who are engaged in commercial, industrial or financial activities in the other Member countries.[12]

The OECD MTC was being primarily, used by the advanced or developed countries (member countries of the OECD[13]) as a framework convention for the conclusion of the BTTs among themselves.[14] The primary purpose of the MTC is that it provides a harmonized and acceptable language at a given regional or sub-regional level. OECD MTC, no doubt, serves this purpose. The evolution of the UN MTC was to facilitate harmonizing process within the developing countries.[15] Most of the countries follow the OECD MTC. Even the developing countries used to follow them until the UN MTC came into existence. The OECD MTC along with its Commentaries has been considered as an effective model for a large number of negotiations of BTTs within the OECD regime.

[10] Draft Double Taxation on Income and Capital, Report of the OECD Fiscal Committee, Paris, 1963, p. 9; see also Peggy S. Musgrave, *Tax Policy in the Global Economy: Selected Essays of Peggy S. Musgrave*, (UK: Edward Elgar Publishing Ltd., 2002) at p. 358.

[11] Draft Double Taxation Convention, at p.10.

[12] Ibid at p.9.

[13] It is pertinent to note that when the OECD MTC was framed the then existing members did not include Mexico and Hungary and only 24 countries were the members. These countries were considered as developed countries. See Wijnen Willem F G and Marco Magenta, "The United Nations Model In practice," *Bulletin of International Fiscal Documentation*, vol.51, no.12, 1997, p.574-585. The total number of OECD countries are 30 and they are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Republic of Korea, Luxemburg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States of America. Available at OECD web pages: http:/www.oecd.org.

[14] See, M.B.Rao, *Double Taxation Between Developing and Developed Countries*, (New Delhi: Milind Publications Pvt. Ltd, 1983), at p.35. See also Charles E. Mclure, Jr., "Globalization, Tax Rules and National Sovereignty", *Bulletin of international Fiscal Documentation*, vol. 55, no. 8, 2001,pp. 328-41, at p.330.

[15] www.g77.org for the list of developing countries.

The difference in treaty negotiations between two developed countries versus one developed and one developing country is also reflected in the differences between the OECD and UN.[16] The OECD initiated this MTC for the developed or advanced countries. It is based on the 'residence principle,'[17] which seeks to encompass all the investors who are residing in any of the contracting states. The rationale behind the acceptance of this principle shows the non-wavering stand taken by these countries not to waive their right to tax any investor on the ground of his alternate residence because of the existence of level playing field in terms of development, investment, economic conditions and standard of living of these OECD countries.

The United Nations MTC 1980 was framed for the benefit of the developing and transition countries.[18] One of the main reasons for the developing countries to consider the UN MTC is their confidence that it would address the issues and concerns of the developing countries. This model emphasizes on the source principle because many of the developing countries

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[16] Jeffrey Owens, *The Main Differences between the OECD and the United Nations Model Conventions*, in R. Vann, ed., TAX TREATIES: LINKAGES BETWEEN OECD MEMBER COUNTRIES AND DYNAMIC NON-MEMBER-ECONOMIES, Paris: OECD Committee on Fiscal Affairs, (1996), pp. 49-56. Owens provides a detailed comparison of these two agreements and concludes that the UN MTC favors source taxation whereas the OECD treaty emphasizes residence-based taxation. For example, the OECD MTC imposes withholding tax rates while the UN MTC does not. Since greater emphasis on source taxation reduces the revenue transfer problem, this suggests that t'·e UN MTC may in fact be a better fit for tax treaty negotiations between rich and poor nations. Similarly, Vann notes that as some less-developed countries have grown, particularly the Asian economies, their tax treaties have moved from the UN MTC towards the OECD MTC.

[17] There are two basic principles on the jurisdiction to tax namely (1) Residence based principle (2) Source based principle. Double taxation can occur when transnational corporations/firms have their business in both host and home country, which leads to the right to tax their income by the states. The residence and the source principle are based on the territoriality principle and the fiscal domicile principle. See UNCTAD *World Investment Report*, n. 2, at p. 77. Residence principle of taxation would involve taxing income regardless of where it arose at the point of residence of the person, actual or legal, to whom that income accrues. On the contrary under the source principle, the income of the individual and the company is taxable. Individuals shall be taxable where the income accrues to them and companies shall be taxable where income-producing transactions take place. See also Parthasarathi Shome, *Tax Policy Handbook,* (Fiscal Affairs Department, IMF, 1995), at. p. 216.

[18] See Stanley S. Surrey, "United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries", *Harvard International Law Journal,* Vol. 19, no.1, 1978, p.1-70; see also Bart Kosters, "The United Nations MTC and its Recent Developments," *Asia Pacific Tax Bulletin*, vol. 10, no. 1-2, 2004, p. 4.

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are 'capital importing countries' and generally a base for foreign investment by the TNCs, or other entities. There was dissatisfaction with the emphasis on the residence based principle on taxation of foreign investment in the OECD MTC and was blatantly objected by the developing countries and a few of the developed countries too.[19] Another reason was the disadvantageous position of the developing countries when they adopted the OECD MTC. Prior to the 1980 UN MTC, few developing countries had BTTs with developed countries based on OECD MTC. Once they started following residence principle it became evident that income flows only in one direction, that is to say, to developed countries due to different levels of economic development. Another principle of great significance is the 'reciprocity principle' in an agreement between two developed countries. It became gradually evident that it is impractical and inapplicable when taken up in an agreement between developed and developing countries due to the great difference in economic status.[20]

This aspect is well elaborated by Charles R. Irish (1974); who points out the reasons why the OECD MTC (which follows residence principle) may not be followed by the developing countries and argues why the developing countries should follow the source based principle. The main reasons can be summarized as follows:

- Ignorance of the developing countries in assessing the disadvantages when they adopt residence principle in their BTTs.
- Internal tax laws of certain developed countries inhibit the flow of capital, technology and services to any forms and conditions, which eliminate such restrictions.[21]

Apart from this, more importance should be given to the period for the negotiations of the UN MTC, i.e., from 1967 to 1979, when the *Ad Hoc* UN Group of Experts started working on this issue. This period is considered crucial

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[19] See Beveridge, n. 3, at p. 86.

[20] Charles R. Irish, "International Double Taxation Agreement and Income Taxation at Source", *International and Comparative Law Quarterly* vol.23, 1974, pp. 292-316, at p.292.

[21] Ibid, p. 301.

for the developing countries,[22] as the period is prime when the negotiations were going on for Charter of Economic Rights and Duties of the States (CERDS)[23] and the New International Economic Order (NIEO).[24] This shows the struggle for attaining the economic sovereignty and self-determination on the part of the developing countries. Thus, they felt the need to negotiate the framework MTC under the auspices of the UN, based on source principle, as deemed appropriate.

The OECD MTC is considered a perfect model to be followed when it comes to negotiating a multilateral tax treaty uniform to all because it has been very influential. Phillip Baker[25] explains the reason for the OECD MTC being highly influential on subsequently negotiated BTTs, which according to him are due to;

(i) The increase in the number of tax treaties between and among OECD member countries, along with the adoption of the pattern and main provisions of the OECD MTC, in accordance with the recommendations of the Council of the OECD;

(ii) The OECD MTC has been used as a 'basic document of reference' during negotiations for a BTT even between and among (a) member and a non-member countries and (b) non-member countries; and

(iii) Lastly, the Commentaries to the OECD MTC have widely been accepted as a guide to the interpretation and application of the provisions of existing bilateral treaties.

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[22] See F. V. Garcia-Amador, *The Changing Law of International Claims,* (Oceana Publications, Inc., 1984), vol. II, at p. 617.

[23] General Assembly Resolution 3201 (S-VI) of 16 May 1974 on '*The Declaration on the Establishment of a New International Economic Order*'; and General Assembly Resolution 3202 (S-VI) on '*Programme of Action on the Establishment of a New International Economic Order*'; Official Records of the General Assembly, Sixth Special Session, Supplement No. 1 (A/9559) (New York: United Nations), p. 3-12; reproduced in 13 ILM (1974) pp. 715-766.

[24] General Assembly Resolution 3281 (XXIX) of 15 January 1975: '*Charter of Economic Rights and Duties of States,*' Official Records of the General Assembly: Twenty-ninth Session, Supplement No.31 (A/9631) (New York: United Nations), p. 50-55; reproduced in 14 ILM (1975) pp.251-265.

[25] See Baker, n. 6, at p. Int-12, 13, 14, and 15.

Though the OECD MTC was proposed to be a perfect model for a uniform multilateral tax convention,[26] many scholars have disputed it.[27] Richard J. Vann opines that "adoption of the OECD MTC as the solution to international tax problems is a concept whose time has come – and gone."[28] He substantiates this statement on these grounds;

1. In relation to arm's length taxation approach,[29] the OECD Model is non-neutral in its impact on taxpayers' behavior and subjecting them to different types of income to different taxation regimes encourages the taxpayer to re-characterise income to get best tax results.
2. By separate treatment of related companies, it is indirectly encouraging treaty shopping and transfer pricing.
3. The reciprocity approach underlined in the OECD MTC is unrealistic and just a formality since there would be other criteria to tax the taxpayer with respect to certain other income. The distinction between both the MTCs would be dealt in detail.[30]

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[26] See Victor Thuronyi, "International Tax Cooperation and a Multilateral Treaty", *Brooklyn Journal of International Law*, vol. 26, no: 4, 2001, p.1641-97 at p.1662. In favour of OECD MTC, Thuronyi argues "the very success of the OECD Model for a bilateral treaty has made it propitious to replace the bilateral network with a multilateral treaty". See also Alex Easson, "Do We Still Need Tax Treaties", *Bulletin for International Fiscal Documentation*, vol. 54, no. 12, 2000, p.619-25, at p.620: wherein he makes a remark that the "achievement of OECD Model Convention in establishing an almost universally accepted international tax regime" is remarkable and therefore a great success.

[27] See R.S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification", *Texas Law Review*, vol.74, 1996, p.1301, at p.1304., wherein he comments that the "Miracle is flawed".

[28] Richard Vann argues that the OECD Model has become increasingly inefficient and irrelevant. In his words "Adoption of the OECD Model as the solution to international tax problems is a concept whose time has come – and gone" in Richard J. Vann, "A Model Tax Treaty for the Asia-Pacific region?" (Part I) *Bulletin for International Fiscal Documentation*, vol. 45, no. 3, 1991, p. 90 at 102: Part II was published in vol.45, no.4, 1991, p.151.

[29] Art. 9 of the OECD MTC can be treated as the source for the definition of arms' length principle. It states "when 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 enterprise but, by reason of those conditions, have not so accrued, may be included in the profit of that enterprise and taxed accordingly."

[30]See for details of discussion the distinction between the OECD MTC and UN MTC under Chapter II. 4.2. at p.11.

2. 2. 1. The OECD Model Tax Convention, 1977

The brief history of the OECD MTC would describe the characteristics of it. The two International Fiscal Conferences in 1920 and 1922 respectively, recommended the League of Nations to consider and examine the problem of double taxation and fiscal evasion. On its basis Committee of Technical Experts was constituted and the draft model came into existence in 1928. These drafts raised issues of uncertainty and disparity on the taxation of those taxpayers who conducts their business in foreign countries. Thus, a Fiscal Committee of the Organization for European Economic Cooperation (O.E.E.C),[31] was formed to study the impact on international commercial transactions. Later, the O.E.E.C countries along with United States and Canada formed OECD and under its auspices, in 1963, came out with the OECD MTC on Income and Capital. In 1997 it was revised. The prime purpose of the 1977 Convention was to scrutinize all the questions legal, theoretical or practical that had arisen in the course of time.[32]

The evolution of the MTC itself shows that the intention was to have certainty on the issue of taxation of the taxpayer who conducts business in other countries and also to have a clear law on international commercial transactions. The reasons could be attributed to the known fact that the OECD member countries were 'capital exporting countries', apart from other reasons, which are;

(a) Better bargaining position since the taxpayer resides in that state.

(b) The domestic tax system of the developed countries is residence based.

(c) Reciprocity condition and good faith principle.

Two developed countries entering into transactions on trade and investment had same level of development, so they preferred to have a BTT,

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[31] Organization for Economic Cooperation and Development Fiscal Committee, Report, Draft Double Taxation Convention 7 (1963), the outstanding work of the League of Nations on the issue of double taxation avoidance was carried on by the Fiscal Committee of the OECD and thus the evolution of the OECD MTC. See Baker, n. 6, at p. Int-1-3.

[32] See Oscar M. Trelles, *II*, "Double Taxation/Fiscal Evasion and International Tax Treaties" *Indiana Law Review*, vol. 12, no. 2, 1979, pp. 341-78.

based on residence principle.[33] This MTC which came to be widely accepted was revised[34] several times to meet the changing needs of the countries.

2. 2. 2. The United Nations Model Tax Convention, 1980

The aftermath of colonialism which indicated an increase in trade and investment which necessitated in the regulation of trade, to prevent the emergence of economic colonialism.[35] The strong feeling of economic self determination by the then newly independent states (developing countries) strived them to have a different approach towards the Tax Treaties, as they felt that these tax treaties also would constitute an FDI determinant. Thus this Convention came into existence when there was a need for tax treaties between developed and developing countries.[36] The convention is based on *source principle of* taxation.[37] Under this MTC, 'persons' who are liable to be taxed includes an individual, a company and body of persons (but not an entity). Therefore the question of taxation of a company is highly relevant, since the United Nations MTC easily assumes the existence of permanent establishment of a business enterprise. The major difference between residence and source

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[33] Second sentence of Article 4 (1) and Art.12 (1) of OECD MTC favour exclusive taxation by the country of residence of recipient of income. Article 12 (1) reads thus; "1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxed only in that other State if such resident is the beneficial owner of the royalties". It differs from the UN MTC as it does not mention that the resident state "may" tax the person. See Charles Irish, "International Double Taxation Agreements and Income Taxation at Source", *International and Comparative Law Quarterly*, vol.23, 1974, p. 292-316, at p. 294; see also Fiona Beveridge, n. 19, at p. 86.

[34] The first revision was in 1977, followed by five subsequent revisions in 1992, 1994, 1995, 1997 and 2000. See Klaus Vogel, "Changes to the OECD Model Treaty and Commentary since 1992", *Bulletin for International Fiscal Documentation,* vol. 51, no. 12, 1997, pp. 532-8 at p. 532.

[35] See Bart Kosters, "The United Nations MTC and Its Recent Developments", *Asia Pacific Tax Bulletin*, vol.10, no.1/2, 2004, pp.4-11.

[36] The UN Model which was adopted by and large by the developing countries can be affirmed by the fact that after the fall of the Eastern blocs, the then newly independent states and the other Eastern European economies in transition had incorporated in their national models many of the provisions of the UN Model; see Bart Kosters, ibid.

[37] See, Beveridge, n. 3 at p. 50. Further, Article 11 on Interests and Article 12 on Royalties though not expressly prohibit taxation by country of residence, but impliedly states that it is the country of source that has right to tax.

principles is based on close economic connection and relationship between the taxpayer and the country. While the residence principle establishes a relationship between a country and a taxpayer, the source principle relates back to the nexus between the income and the countrv, that is, income should be taxed in the country with which it has economic connections. For instance, taxation of a Permanent Establishment is assessed not only as per the activities of the establishment but also the "force of attraction" test is applied.[38]

The need to revise the UN MTC was felt when the OECD MTC was revised in 2000 in order to bring both the conventions at par with each other. Salient Features of the revised UN MTC, 2001[39] is with respect to the changes incorporated in concept of resident, permanent establishment,[40] associated enterprises, capital gains and independent personal services. As per the revised version resident also includes states and their political subdivisions or local authorities.

With respect to associated enterprises a significant change has been made. Earlier it allowed a contracting state to make transfer pricing adjustments in the event inter-company pricing not at arm's length. The revised version mandates that a contracting state may impose tax or non-tax penalties on the taxpayer. Thus, the revision is significant for it is trying to incorporate the needs according to the changes in the present world. In the light of these revisions and changes incorporated, it becomes essential to look at the different salient

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[38] For a discussion on the problems concerning ''force of attraction" principles with GATT obligations see Zernin J.Fischer, "GATT versus Tax Treaties : The Basic Conflict between International Taxation Methods and the Rules and Concepts of GATT", *Journal of World Trade*, vol.21, no. 3, 1987, pp. 39-61, at pp. 56-58.

[39] Revised United Nations Model Double Taxation Convention Between Developed and Developing Countries, 2000, see UNCTAD; *International Investment Instruments: A Compendium*, Vol. VI, Multilateral Instruments, (New York and Geneva: 2001), UN Publications Sales No. E.01.II. D.34.

[40] Under the concept of permanent establishment a thorough revision was done. The paragraph that deals with independent agents has been amended that is, Art. 5(7). In the prior UN MTC, if the activities of an independent agent were devoted wholly or almost wholly on behalf of an enterprise, the agent would not be considered to be independent but dependent, thus it constituted a permanent establishment. In the revision it specifies that in order to categorise a not independent agent to be a permanent establishment one has to prove that there is commercial and financial relations between the agent and the enterprise.

features of the MTCs, to understand why there has been distinction between both the MTCs.

2. 3. Features of the Model Tax Conventions

The primary purpose of a tax treaty is to avoid international juridical double taxation to facilitate the international exchange of goods, services, capital, technology and persons.[41] A perusal of the OECD MTC shows that there are few other purposes also.[42] The contents of the MTC include the scope and definition provisions,[43] substantive provisions,[44] elimination of the double taxation,[45] anti-avoidance and associated enterprises provisions[46] and miscellaneous provisions.[47] This study would be an earnest attempt to deal this in five questions, namely;

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[41] See paragraph 1 of the Introduction to the OECD MTC, where international juridical double taxation is 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'.

[42] Certain other purposes are:- (i) prevention of fiscal evasion through the exchange of information (Article 26 of the OECD MTC),(ii) Assistance in collection of taxes (Article 27 OECD MTC), (iii) eliminating discrimination of taxation (Article 24 OECD), (iv) prevention of tax avoidance and evasion (paragraph 7 to the Introduction to OECD MTC)

[43] Scope and Definition provision includes personal scope of the MTC (Article 1). Taxes covered under Article 2 namely Taxes on Income, Capital, Total income, Total Capital including taxes on gains from alienation of movable and immovable property, taxes on capital appreciation and taxes on total amounts of wages or salaries paid by enterprises. Definition provisions – Article 3 of the OECD MTC defines terms like "person", "company", "enterprise of a contracting state", "international traffic and competent authority; Article 4, 5 and 6 define "residence", "permanent establishment", " immovable property" respectively.

[44] Article 6-22 of the Convention deals with the substantive provisions of the OECD MTC relating to Taxation of Income (Article 6-21) and Taxation of Capital (Article 22).

[45] Elimination of double taxation as per Article 23 provides for two methods (i) Exemption (ii) Credit method. Under the exemption method (Article 23A), one state exempts from its tax regime all or part of the income of a taxpayer, leaving the other to tax the income in question. Also, it provides an economic incentive for residents to invest in low-tax countries and not to invest in those with high tax rates. Article 23B elaborates the credit method of double taxation, which means, that the residence state gives the taxpayer credit against his/her tax bill for taxes already paid in source states. It may be partial or full, or may mean only that the residence state will calculate tax due on an amount net of taxes due or paid in the source state.

[46] Art.9 defines associated enterprises, business profits is explained under Article 7 of the OECD MTC.

[47] Miscellaneous provision – Article 26 deals with exchange of information, Article 24 non-discrimination, Article 27 diplomats, Article 28 territorial extension, Article 29 deals with Entry in force; and Art. 30 Termination of the treaty respectively.

1. Who should be taxed;
2. Which income or money should be taxed;
3. Where to be taxed;
4. How to eliminate double taxation of the same money; and
5. How to check double taxation or methods of international cooperation

*2. 3. 1. **Liability to be taxed***

Persons are liable to be taxed under Chapter I of both the MTCs based on their domicile, residence, place of management, etc.[48] Persons include (i) an individual, (ii) a company and (iii) a body of persons or an entity.[49] An individual is taxed based on his residence in the contracting state. Contextually, it is obvious that the term 'residence' should be an important component of taxation under the domestic tax law of both the Contracting states. It is essential for interpreting the term in order to determine an individual's close economic and personal ties to the taxing country.[50] It can be resolved by following either of these methods, namely;

(i) *Facts and circumstances approach*[51] - It means an individual's residence can be determined by tracing his habitual abode, permanent home, personal and economic relations.

(ii) Concept of residence under *civil laws* - of the country also will be helpful in determining the residential status of an individual; and

(iii) *'Thumb Rule'* relates back to the physical presence of the person in the country, for a minimum period of 183 days of an accounting

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[48]Article 4 para. 1 of the UN MTC, see Appendix II.

[49] The category of persons in the UN MTC does not include "any entity". An entity is included in the definition of persons as per commentary to Article 3 of the OECD MTC.

[50]Article 4 para. 2 of the UN MTC.

[51] Article 4 paragraph 2 (a) and (b) of the UN MTC. Facts and circumstances approach, helps in determining an individuals place of residence based on the facts placed before the authorities, for example, "permanent home, personal and economic relations and habitual abode of the individual", see Richard Vann, n. 5, at p. 729. In the tax treaties it would be plainly mentioning the circumstances like permanent home, personal and economic relations and habitual abode. Yet it is argued that this principle should be clubbed some other tests so as to be effective.

year.[52] On the other hand, a company or a corporation or a legal entity is considered a resident in any of the Contracting states based upon the 'control of management' test.

There are certain other methods also[53] for determining the nationality of a corporation or company, like, place of incorporation and place of management methods.[54] Place of incorporation test means the country under whose laws the corporation came into existence and place of management basically refers to the country of meetings of the Board of Directors.

2. 3. 2. Income or Money to be taxed

Income of a person can be taxed under two categories; (i) Taxation of business income and (ii) Taxation of investment income. For a perusal of the concept of business income, it is vital to understand the definition

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[52] There is a wide criticism of *the 183 days* test (as given in the OECD MTC) that if every residence country adopts this rule or test then, it is a possible assumption that the same individual can be a resident in two countries at the same time, if he has dual residence. Further, as per Section 6(1) of the Indian Income Tax Act, 1961, an individual is a resident in India only if

(i) He is in India in the previous year for a period of 182 days or more.
(ii) He is in India for a period of 60 days or more during the previous year and 365 days or more during 4 years immediately preceding the previous year.

[53] See, M. Tedeshi, "The Determination of Corporate Nationality", *Australian Law Journal*, vol. 50, 1976, p. 521, where he gives 5 methods to test the residence of a corporation –

(i) place of incorporation method
(ii) place of principal business activity,
(iii) depending on the residence or nationality of its shareholders
(iv) nationality of its shareholders
(v) location of control test.

But, usually it is based on the *control of management* test to decide the nationality of a corporation,, founded upon the fact of the original place of control of the business activity, its operation etc under the OECD MTC it is the place of effective management that acts as a mechanism to determine the residential status of a corporation as per Article 4(3). This provision reads thus; "Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated."

[54] According to section 6(3) of the Indian Income Tax Act, 1961, a company is Indian resident if the control and management of its affairs is situated wholly in India. The term "control and management" denotes "head and brain" of the company, i.e., affairs of policy, finance, disposal of profits and vital things concerning company's management. Place of Meetings of the Board of Directors does play a significant role in it.

and interpretation of a "permanent establishment."[55] According to Article 5 paragraph 1 of the OECD MTC, a permanent establishment means,

> "a fixed place of business through which the business of an enterprise is wholly or partly carried on, and is inclusive of the place of management, branch, office, factory, workshop, mines or gas well, a quarry or any other place of extraction of natural resources."[56]

Moreover, the concept of business profit of a foreign enterprise is interlinked with a permanent establishment. The terminologies like permanent establishment, associated enterprises and business profits are closely intertwined, when determining the taxability of *business income* of a foreign enterprise. The business income is again classified into exports and business profits, personal services which include dependent and independent services, director's fee, pensions, government services, students, shipping, inland waterways transport and air transport and purchases. The category of investment income is divided into, dividends, interests, royalties, income from immovable property, capital gains and income from other sources.

The taxation of person other than individuals, like companies or entities (be it multinational companies), becomes highly relevant because they play a pivotal role in increasing the revenue of a state. These companies establish their branch in other countries in order to increase their profits by investing there. For examining the status of the branches or subsidiary,

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[55] Art. 7(4) of the OECD and UN MTC provide that a country can maintain customary method of calculating the profits of branches, so long as the result is in accordance with the principles of the MTC. Art. 7(1) of the OECD MTC explains "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...". Further, see Parthasarathi Shome, "The 1990's revolution in Tax Policy", *Bulletin for International Fiscal Documentation,* vol. 51, no. 1, 1997, pp.431-7., wherein he analyses how the concept of Permanent Establishment has become so important in order to find out whether such an establishment is "trading in a country" or "trading with a country". If it is trading in a country, it is evident when it has a fixed presence, carrying out business activities over a period of time or having its independent status in its business transactions. The concept behind business profits is to tax the profits of an enterprise in a country where it carries on its business through permanent establishment.

[56] Art.4 (3) of the OECD MTC Convention; see D. P. Mittal, *Indian Double Taxation Agreements and Tax Laws*, (New Delhi: Taxmann Allied Service Pvt. Ltd, 2001), at paragraph 2.13-3. Wherein the author suggests the test for determining a business presence of a Permanent Establishment, They are (i) Objective test (by the presence of substantial physical object), (ii) Subjective test (right to use with some permanence), (iii) Functional test (business activity or connection).

terminologies like transfer pricing[57] and arm's length principle, etc should be referred. The concept of *transfer pricing* is generally referred to the problem of allocation of profits among the parts of a corporate group. It is necessary to allocate profits among the companies in the group because under international tax norms, a country has the right to tax the nonresidents too on the profits sourced in that country. *Arm's length principle* is applied to determine whether any of the branch's profits could be attributed to a foreign company. It is usually the terms like business profits and associated enterprises as defined under Article 7 and 9 of the OECD and UN MTC, that are used to confirm a branch's status as a subsidiary to a foreign company and thereby taxing them within the purview of permanent establishment.

It is an undisputed fact that, one of the major issues addressed through the DTACs and BTTs (which fall within the conglomeration of international tax law) is the issue of transfer pricing by transnational corporations.[58] The reason is clear, that each firm, including associated firms, are considered separate entity for the purpose of taxation, and arm's length principle is the yardstick to establish that it is a separate entity.[59]

2. 3. 3. Jurisdictional Issues

According to the basic principles of taxation two states have the right to tax income accruing to a person. They are (a) the State of residence and (b) the State of source. It has been stated earlier that the OECD MTC follows the residence principle and the UN MTC follows the source principle to levy tax. The residence principle signifies the nationality or domicile principle in order to assert that natural persons or any individual is liable to be taxed in the country or tax jurisdiction in which they have their residence, domicile or

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[57]This problem have been addressed by the OECD in part and the standard is set according to the Transfer Pricing Guidelines for MNE's and Tax Administrations (OECD, 1995) and the United States Regulations section 482 of the Internal Revenue Code. It is widely accepted as an international standard.

[58] See United Nations Conference on Trade and Development (UNCTAD, 1999 a). '*Transfer Pricing*' UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations), United Nations Publications, Sales No.E.99.11.D8, at p.1.

[59] See UNCTAD World Investment Report 1998: Trends and Determinants, n. 6 at p.78.

physical residence; immaterial as to where the source of income arises. For a legal or artificial legal entity, it is always based on the place where it carries out its business activities, or its place of incorporation or place of management of business.

The source principle emphasizes on the country where the income accrues or arises. Under this principle it depicts the relationship between income and the country while in the former it is the nexus between the taxpayer deriving the income and the country where he derives the same. The primary intention is to accord that state with the right to tax in which there is substantial business connection. There are certain provisions in the OECD MTC which deals with the source principle or somewhat shared taxation[60], say like interest,[61] dividends etc. Therefore, the nature of taxation right of a state can be determined based on what type of principle it follows by interpreting their tax treaties.

2. 3. 4. Elimination of Double Taxation on the same money

Another basic principle of taxation is, on the method of eliminating double taxation, which are; a) Tax Exemption method, b) Tax Credit method and c) Tax Sparing method. Both the MTCs, deal with the two methods of the elimination of double taxation which are tax exemption and tax credit method. Elimination of double taxation is the primary purpose of the MTCs, the two methods of which are tax exemption method (Article 23 A) and tax credit method (Article 23 B). The first method is applied so that the exemption of foreign-source income from taxation by the country of residence may place the investor in a position of tax equality with the residents of the source country. The countries which follow exemption method do not exempt dividends, interest and royalties from the foreign sources from domestic income

[60] Shared taxation means the source country may levy a withholding tax at a rate not exceeding that set forth under the treaty and the country of residence may tax the income received but must grant a credit against its own for the withholding tax levied in the source country. See UNCTAD, 1996 a, *International Investment Instruments: A Compendium*, vol. II, (New York and Geneva: United Nations), UN Publications, Sales nos. E.96,11. A.79.

[61] Article 11(5) of the OECD MTC.

tax. In fact, the investor's country of residence exempts from taxation certain items of income from foreign sources.

The second method signifies that countries following this method reduce their normal tax claims on foreign profits by the amount of tax the investor has already paid at the source country. Tax sparing method denotes those incomes of foreign investors which are spared from taxation in order to transfer the revenue to the capital importing source country. This is a new method which has been adopted by Canada, France, Japan, Germany and United Kingdom.

2. 3. 5. International Cooperation

The Exchange of Information and Assistance in Collection, and Mutual Agreement Procedure are the two methods to check the effectiveness of taxation in the other contracting state. These procedures signify the relevance of international cooperation and understanding in good faith. [62] We shall examine each of them, since they are highly important from the standpoint of both the Contracting States.

2. 3. 5. i. Exchange of Information and Assistance in Collection:

One of the most important provisions of a Tax Treaty is the Exchange of Information (Article 26 of both OECD and UN MTC) clause because 'lack of effective exchange of information' was considered one of the important factors for determining whether a country practices harmful tax competition or not.[63] The specialty of this clause remains with the necessity of

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[62]Article 2 paragraph 2 reads, "All members, in order to ensure to all of them the rights and benefits resulting from membership, shall fulfill in good faith the obligations assumed by them in accordance with the present Charter." Also see the *Declaration on Principles of International Law Concerning Friendly Relations and Cooperation Among States in Accordance with the Charter of the United Nations, 1970,* also emphasizes in its Preamble "Considering that the faithful observance of the principles of international law concerning friendly relations and cooperation among states in accordance with the Charter, is of the greatest importance for the maintenance of international peace and security and for the implementation of the other purposes of the United Nations," see, Ian Brownlie, *Basic Documents in International Law,* (Oxford: Clarendon Press, 1972), at p.35.

[63] Report of the OECD entitled "*Harmful Tax Competition: An Emerging Global Issue*" (Paris: 1998).

exchanging information about one's own country's tax administration, thereby raising an issue of the existence of national sovereignty over fiscal matters, which is purely a state's right. This rule acts as an exception to the general practice of states in not directly assisting another country in the collection of taxes.[64] Article 26 of the UN MTC has some unique characteristics since the Group of Experts while framing this clause emphasized on two aspects, firstly, that Article 26 should be an instrument to combat tax evasion and, secondly, competent authorities have a definite role to play.[65]

Domestic tax laws of most of the countries mandates a rule that states would generally not hand over any information directly or indirectly to another country even by way of assisting them in the collection of taxes. Exchange of information is an exception to this domestic law rule, since a tax treaty overrides this rule of domestic law. Incorporated in Article 26 of both OECD and UN MTC, this provision was intended to prevent fraud or evasion of tax.[66] The relevance of these mechanisms occurs when one may delve into the conditions for exchanging information.

The two queries that would arise are: (a) what information and (b) under what conditions can they be exchanged. The rule requires exchanging the information when it is *necessary* and absolute *secrecy*[67] of such information should be maintained. Secrecy should be maintained in accordance with the secrecy rules of the domestic law of the recipient country and treaty rules. There

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[64] This rule is found in the conflicts of law (private international law) as cited in Richard J. Vann, n. 5.

[65] See Klause Vogel, *Double Taxation Conventions* (Kluwer Law International: 1997) as cited in Francisco Alfredo Garcia Prats, "Exchange of Information Order Article 26 of the UN Model Tax Convention," *Bulletin of International Fiscal Documentation*, vol.53, no.12,1999, pp. 541-8 at p.542.

[66] See Prats, Ibid.

[67]In an explanation of the savings tax agreement, the European Community noted that BTT contain exceptions that prohibit countries from exchanging certain information, and that "there are no common rules concerning the details of the information to be reported, the format and frequency of exchanges" with the result that information is often incomplete or unusable. See Suzanne Walsh, "Taxation of Cross Border Interest Flows: The Promises and Failures of the EU Approach," *George Washington International Law Review*, vol. 37, no. 1, 2005, pp. 251-92; also OECD: *Improving Access to Bank Information for Tax Purposes* p. 7-17, (2000), http://www.oecd.org/dataoecd/3/7/2497487.pdf.

are certain difficulties with respect to exchanging information on bank secrecy because it is a basic rule of banking that they should maintain absolute secrecy about their customer's account. Therefore, obtaining such information from bank of another country becomes difficult and these have been regarded as a necessary condition to curb international tax competition. The treaty provisions do not emphasis on exchanging information when it involves commercial or trade matters. However, the procedure for determining whether there is a necessity to exchange information arises only when there is a request by a contracting party to obtain such information to carry out the provisions of the convention or of the domestic laws of the contracting states. Such a Contracting State is required to 'supply documents',[68] on request, which can be implied to be an obligation. Moreover, the other Contracting State has a discretion to inquire whether the requesting state has exhausted all remedies as laid down in their domestic laws. It also depends upon the willingness of the taxing authorities to share the data necessary for effective enforcement of residence-based taxation, especially if the country is a tax haven.

2. 3. 5. ii. Mutual Agreement Procedure

From a layman's perspective, this provision is crucial as the available remedial procedure. Mutual Agreement Procedure as defined under Article 25 of the UN MTC serves three major purpose; namely,

(i) As a dispute settlement mechanism with special reference to certain cases under the tax treaties;

(ii) Settlement of common interpretations and applications of the tax treaty;

(iii) Provision for a mechanism to deal with cases of double taxation which otherwise is not dealt in their treaty. In addition to other relevant provisions, this article[69] states that whenever a 'person' has

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[68] Such documents include depositions of the witnesses, authenticated copies of unedited original documents (including books, papers, statements, records, accounts, or writings, etc.

[69] Article 25 of the UN and OECD MTC refers to the Mutual Agreement Procedure. Article 25 (1) of the UN MTC reads thus;

some legal problem with respect to any action by any of the Contracting States which results in taxation not in accordance with the Convention, such a person has the remedy of *presenting the case before the Competent authorities of his state irrespective of the remedies available to him under the domestic tax laws,* provided he presents the case within three years from the first notification of the action. Under these provisions, whenever an objection is raised by a taxpayer and is justified, then the competent authorities of both the Contracting states are required to make efforts to find a solution through mutual agreement[70].

Further, under Article 25 of the OECD MTC, if any term is not defined in the convention and is subject to the interpretation, then the Convention provides that through Mutual Agreement Procedure the Contracting States may reach an agreement on the meaning of such term[71]. Yet, this provision is not effectively applied due to the emergence of Advance Pricing Arrangements (APA)[72] that uses this procedure to transfer price in advance. Thus, these provisions have a major role in shaping the tax law of a country and thereby transform the tax treaty interpretation in cross- border transactions.

These being certain important features of both the MTCs it become essential to delve into the two conventions and examine their differences.

"Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance wit the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those states, present his case to the competent authority of the Contracting State of which he s a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation which is not in accordance with the provisions of the Convention."

[70] Article 25 (2) of the UN MTC refer Appendix II.

[71] Catherine Brown and Christine Manolakas., "Trade in Technology within the Free Trade Zone : The Impact of the WTO Agreement, NAFTA and Tax Treaties on the NAFTA Signatories", *Northwestern Journal of International Law and Business,* vol.21, no.1, 2000, pp.71-129.

[72] This is a practice in industrialized countries.

2. 4. The OECD and UN Model Tax Convention: Areas in Conflict

Though there are very limited differences or distinctions between OECD and UN MTC, it is necessarily to examine them for a clear understanding of the implications of these tax conventions. The difference between these two MTCs could be seen in the following provisions on an analysis they are as follows:

Sl. No	Relevant Article	OECD MTC, 1963.	UN MTC, 1980.
1.	Article 4	'Residence'-in paragraph (1), it mentions that the residence state cannot tax a person merely on account of is income from sources or capital situated there.	This sentence is not present in this convention.
2.	Article 5 Paragraph 3a	'Permanent establishment'[73] – (1) The duration of a *building site or construction or installation projects* is twelve months, (2) This model does not include any supervisory activities and projects, Use of facilities or the maintenance	(1)The period is six months (2)The term Permanent establishment includes any supervisory activities and projects, Use of facilities or the maintenance of stock for the purpose of delivery of goods or merchandise, an insurance company collecting premiums in another country.

[73] Permanent establishment can be defined as an existence of any continuing and permanent nature of a foreign enterprise in another country, which is attributable to a 'fixed place of business' in another country and is of such a nature that it would amount to an effective projection of a foreign enterprise of a country into the soil of another. "A Place of business means all tangible assets used for carrying on the business; in marginal cases, one such tangible good is sufficient. The term covers both premises and other tangible assets used by the enterprise." See Klause Vogel, *Double Taxation Conventions* (Kluwer Law International: 1997) at. p. 205; See also *CIT* v. *Visakhapatnam Port Trust* [1983] 144 ITR 146 (AP).

	Paragraph 3b Paragraph 4f	of stock for the purpose of delivery of goods or merchandise, an insurance company collecting premiums in another country. (3) Not included in this model. (4) On maintenance of fixed place of business for the provisions mentioned from paragraph (a) to (e) is not included.	(3) Furnishing of services, including consultancy services etc. wherein the stay should be for more than 12 months. (4) It is included.
3.	Article 7 Paragraph 1 b & c	'Business Profits'- (1) Only the profits attributable to the permanent establishment would be taxed in that state	(1) The business profits along with the profits that are attributable to the sale of similar or same goods or merchandise is taxable in that state
4.	Article 8	'Shipping, Inland Waterways Transport and Air Transport'- (1)There is no alternate provision.	(1)There is an alternate provision in the UN Model. This provision emphasizes that the profits from the operation of an aircraft, ships, boats, etc. would be taxable in the place of effective management.

5.	Article 10 Paragraph 2 a & b	'Dividends'- (1) Rates of tax with respect to dividends is clearly laid down.	(1) Such tax rates are not predetermined, and they are to be determined at the time of negotiations.
6.	Article 11 Paragraph 2	'Interest' – (1) Rates of tax with respect to Interest is clearly laid down at 10% of the gross amount of interest.	(1) No rates are fixed.
7.	Article 12	'Royalties' – definition of royalties does not include 'films or tapes used for radio or television broadcasting'. Therefore, not an exhaustive definition. Paragraph 3 and 5 is not included.	The definition of royalties is exhaustive.
8.	Article 13 Paragraph 4 & 5	'Capital Gains' – regarding alienation of shares of capital stock of a company, is not included.	This model does include extensively paragraph 4 and 5.
9.	Article 14	'Independent Personal Services' – (1) There is no fixed days test in order to determine the period of stay.	(1) Under this the 183 days concept to determine the period of stay of the taxpayer.
10.	Article 16	'Director's fees' – (1) The omission of the remuneration of top level managerial officials state that	(1) This provision includes Remuneration of Top Level Managerial Officials also.

		they gave importance to the place of management test in which the determining factor is the place where the directors meet.	
11.	Article 23A	'Exemption Method' – (1) Under paragraph 2 of the OECD it gives reference to only Article 10 and 11 and excludes royalties from the exemption.	(1) Under paragraph 2 of the OECD it gives reference to only Article 10, 11 and 12 for the purpose of exemption.

Source: Primary document on both the OECD and the UN MTC.

In summary, the UN MTC does not recommend a particular percentage of withholding tax rates on dividends, interest and royalties. More importantly it omits second sentence of Article 4(1), which limits the treaty concept of residence. On a perusal of the above-mentioned distinctions, it becomes evident that though these conventions are similar in outlook their terminologies differ according to the needs of the nations and nature of the tax system that many of the nations follow. The definitions of permanent establishment, associated enterprises, business profits etc. are exhaustive in the UN MTC, which depicts the intention of the developing countries to have more of foreign investment.

Therefore it is contended that for a country like India or any other developing country it is practical to follow the UN MTC provided they do not have any provision in their domestic tax laws that goes against the principles enshrined in the latter.

Though the UN MTC is widely accepted and followed by the developing countries, there exists a controversy as to whether BTTs based on the UN MTC should be preferred over a multilateral tax treaty? There has been

a movement towards the establishment of a multilateral tax treaty, which has been opposed by few scholars.

2. 5. Tax Treaty: Bilateral versus Multilateral

Avoidance of double taxation has always been the domain of BTTs, which is evident from the large number of bilateral tax treaties entered into between states. The mooted question has been whether there should be a multilateral tax treaty applying uniformly to all nations, or is it the BTTs, which should be encouraged. There are several arguments in favour of and against Multilateralism. The main arguments against a multilateral agreement on avoidance of double taxation or reasons which term a multilateral agreement as impractical are that it is impossible to achieve uniformity in this matter without substantial political will and harmonization of tax systems. However there has been a contention for the 'partial' multilateral approach[74], which is a gradual process.

Victor Thuronyi,[75] advocates for the section wise negotiation of a treaty and he envisions that there should be a uniform text covering the same material as the existing OECD MTC. Whatever the contentions are as to the approaches with regard to multilateral tax treaty, it is submitted that a BTT is advantageous to a multilateral one.

2. 5. 1. Arguments in favour of bilateral tax treaty

The various reasons for favouring the present system of bilateral treaty network are;

1. The impracticability to have a uniform law since different nations have different tax structures. Further, taxation is the heart of all civilized

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[74] The proposal for having a 'partial' multilateral approach has been put forth by Helmut Loukota, *Multilateral Tax Treaty Versus Bilateral Treaty Network,* in Michael Lang, and others, et al., ed., MULTILATERAL TAX TREATIES: NEW DEVELOPMENTS IN INTERNATIONAL TAX LAW (London: Kluwer Law International Ltd., 1998), pp. 85-103, at p. 98.

[75] See Thuronyi, n. 26, at p. 1662.

nations and they would not compromise it just for establishing a uniform multilateral agreement on double taxation.

2. A belief that the loss incurred in tax revenue from a BTT is to be met in a balanced way by both treaty partners through negotiations.[76]
3. Availability of sufficient scope for negotiations between the contracting states on a case-to-case basis, considering the diplomatic, political and economical relations among them. A multilateral tax treaty which favours nondiscrimination would go against the interest of many nations
4. Failure of the various attempts in the past to have a multilateral convention on double taxation.
5. Lack of accomodability of the interests of developing countries prompts them to object to a multilateral tax treaty.[77]

The BTTs give liberty to the Contracting States to include provisions in favour of their economic interests, while negotiating the treaty emphasising that states have equality during the negotiations, irrespective of their economic status.[78] Moreover, the gamut of international tax law on the avoidance of double taxation has been filled with BTTs. The query one would raise at this juncture is whether one nation should follow BTTs or go for a

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[76] In a bilateral treaty whenever there is a dispute, compensation can be claimed from the other contracting state while it would be a lengthy procedure, time consuming process when it is to be claimed through multilateral means.

[77] See Loukota, n. 74, at p. 103.

[78] See Richard J. Vann, "A Model Tax Treaty for the ASI-Pacific Region?" *Bulletin for International Fiscal Documentation*, 1991, pp. 151-63. Vann argues that the Model tax treaty and the network of bilateral treaties which it spawns create an illusion that some element of equality and restraint has been introduced into the inter-state relations, which he says is not reflected in practice:

> "Nations are encouraged to think that the Model will produce formal equality and will restrain more powerful countries in pursuing their self – interests. In fact international tax policy is no different from international policy generally. In the creation of the Model in the first place the policies of the ore powerful countries are likely to be dominant, which is certainly the case with the OECD Model. While some restraining influence is no doubt exercised by treaties concluded pursuant to the Model, more powerful countries can still thumb their noses at treaty obligations where political imperatives so dictate. Small countries in particular need to consider whether their are many significant benefits in the bilateral tax treaties that cannot be obtained in other ways."

uniform multilateral tax treaty. It is always better to accept bilateralism in these matters.

There has been a constant demand for an institution to administer the tax matters, either through establishing an International Tax Organization[79] or a World Tax Court[80] to decide upon the disputes that arise in future. The majority of them uphold the view that the proposed multilateral tax regime should be based on the OECD MTC as it is considered successful, but I for one would argue that following the OECD MTC would not always be beneficial to the developing and transition countries. The need to establish a multilateral regime has been due to the 'pressure from globalization,'[81] and also due to increasing pressure on generation of tax revenue because international transactions afford an opportunity to reduce tax, be it legally or illegally.

In addition, there are examples of countries upholding the terms of the BTT as significant, accentuating that they are agreements concluded after negotiations and that they satiate the economic interest of the nations, even when there has been objections from a large number of people within the country stating that such concessions are detrimental to the national interests.[82]

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[79] When comparing a multilateral tax organization under the auspices of the OECD with the World Trade Organisation regime, it becomes clear that there would be 'uniform global standards' on taxation matters, which is not advisable. Under the WTO, with reference to the Agreement on Trade Related Aspects of the Intellectual Property Rights, uniform standards are set for all countries in relation to IPR protection, irrespective of the economic status of the countries, be it Nepal or US, Rwanda or Japan. See B. S. Chimni, "International Institutions Today: An Imperial Global State in the making," *European Journal of International Law,* vol. 15, no. 4, 2004, pp. 1-37, at p. 7. Therefore, such a uniform standard shall be not be appropriate in taxation matters since nations differ in principle (means basic principles of taxation) in their tax system and policies. See also James Bacchus, "Groping towards Grotius: The WTO and the International Rule of Law," *Harvard Journal of International Law,* vol. 44, no. 2, 2003, pp. 533-50.

[80] The arguments for establishing a World Tax Organization were put forth by John Azzi, "Tackling Tax Treaty Tensions: Time To Think About an International Tax Court", *Bulletin of International Fiscal Documentation*, vol.52, no.8/9, 1998, pp.344-57.

[81] See Thuronyi, n. 26, at p. 1667.

[82] Though *Shiva Kant Jha* v. *Union of India* has been overruled by the Supreme Court of India it explains the grievances of the public regarding the concession given to FIIs in Mauritius. The India-Mauritius tax treaty was the subject of interpretation in that case.

2. 6. Globalization and Double Taxation

The integration of economic policies due to globalisation and the resultant dilution of the sovereignty concept of states (like emerging democracies in Eastern Europe, former Soviet Union and also well established nations like Europe and the America[83]) raised the apprehension of states regarding the reassertion of their right to shape independent economic destiny.[84] The impacts of globalization[85] on taxation laws are immense. Therefore, a study of the world order before and after globalisation is pertinent to understand the effect of globalisation on taxation.

2. 6. 1. Effects of globalisation on taxation

One of the major transformations that took place through globalisation was the opening up of the markets emphasizing on the free trade between nations. As a result there were no barriers on cross border transactions. It became a global village wherein every product or goods moved faster and was available, immaterial of the distance between nations. Relying on the theory of comparative advantage, the prominence was to share the goods, services, capital, etc between the nations. Relaxation was given to certain trade restrictions in order to promote free movement of goods. It could be seen that

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[83] See Jeffrey Owens, "Taxation within a Context of Economic Globalization", *Bulletin of International Fiscal Documentation* Vol. 52, No. 7 (1998), at pp. 290-96.

[84] The economic interdependency between countries have been the factor for delimiting the freedom of the domestic policy makers to determine their own economic policies. Before globalization, the economic policies were good enough as they fitted into both international and national scenario. The international level would mean international trade while national would mean social, industrial, tax policy etc. see Owens, ibid, at p. 290.

[85] According to Vito Tanzi, "The Impact of Economic Globalization on Taxation", *Bulletin for International Fiscal Documentation,* vol.52, no.8/9, 1998, pp.338-43. Globalization implies that many national policies come to have effects beyond a country's border. He argues that the issue of taxation has its world implications. The reasons are that "the tax systems of many countries developed when trade among countries were largely controlled and limited and large capital movements were non-existent." During that time due to high tariffs, or by physical impediments to the free flow of capital, every individual and company used to work or trade within the territory and states taxed them based on the 'territoriality principle'. The term globalization would mean that the closed economies that functioned earlier changed its nature of trading to open economy. See also Beveridge, n. 3, at p.88.

there was a gradual increase in the flow of foreign investment. Subsequently, the investments were made in those countries, which had low tax rates. In effect, the sole motive of any company was to earn profit and not to play a significant role in economic growth of the host country.[86]

The investors started investing in countries with low tax rates.[87] This lead to a lot of controversy and discontents among nations as they were at a disadvantageous position because these investors started investing in other countries. It was inevitable for the major developed countries to regulate them so that they do not incur heavy loss of revenue. Therefore, they pressurized the OECD to bring out defensive measures which would be sufficient to act as an obligation on the part of those countries which follow low tax rates. On the basis of which the OECD brought out two reports which named such practice of these states as Harmful Tax Practices and such states as uncooperative jurisdictions.

Objecting to the Reports of the OECD, certain nations argued that such defensive measures were against the general principles of WTO, which upholds the principle of non-discrimination, MFN treatment etc. Many of the uncooperative jurisdictions (tax havens countries) kept advance commitments[88] fearing the adverse effects of noncompliance. These countries felt that their fiscal sovereignty is at stake as the terms and conditions were being dictated to them while being well aware that the OECD's recommendations are not legally binding except for the member countries.[89] In

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[86] M. Sornarajah, *The International Law on Foreign* Investments, (Cambridge: Cambridge University Press, 1994), at p. 342. He argues that,

> "The idea that foreign investment is motivated by altruistic motives of developing the economy of the host state is such an absurdity that it can hardly be the basis of any rule that deserves even a casual consideration. Transnational Corporations which rule overseas investment are not charitable institutions doling out largesse but are companies in search of profits...."

[87]Tax treaties are one of the determining factors for investing in a country. See UNCTAD, *World Investment Report,* n. 6., at. p. 78.

[88] Regarding the advance commitments, it will be discussed in section 2. 6. 3.

[89] The OECD came into force on September 30, 1961, to promote policies designed to;

[1] [A]chieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy; [2] contribute to sound economic

this section we shall examine the relevant provisions of the GATT and WTO on taxation, role played by globalisation in the emergence of the tax haven countries, compatibility between the OECD and the WTO on the double taxation avoidance issues and lastly, how far e-commerce has been able to redefine the terms permanent establishment, business profits etc. We now move on to the multilateral approach on taxation under the international trade regime.

2. 6. 2. Other multilateral approaches to Taxation like GATT and the WTO regime

Globalization has increased the pace of integration of national economies and new technologies opened up the door for entirely new structures in international trade. The purpose of the GATT regime is promotion of free trade[90] among member states. The GATT and the WTO[91] regime deal with income and other direct tax matters. Close analysis of the main provisions of the GATT Agreement reveals the nexus between taxation and international trade law. Under the GATT 1947, there were references made to taxes on goods. Income tax matters were excluded from the purview of GATT. The first tax of concern is the tariff and next comes the indirect taxes[92]. A tariff is a tax imposed on imported goods at the time of entry of the goods (as a condition to enter) into the territory of a state. On the other hand, indirect tax would be defined as sales,

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expansion in Member as well as non-member countries in the process of economic development; and [3] contribute to the expansion of the world trade on a multilateral, non-discriminatory basis in accordance with international obligations. See OECD Report of 2000, at p. 2.

[90] Free trade as propagated by Adam Smith means free trade without any restrictions. Free world trade also benefits the development of the less developed countries by providing material means which are indispensable for the economic development, capital transfer from developed to developing countries, etc., it can be termed as a means to disseminate technological knowledge, transmission of ideas, for the importation of know how, skills, managerial talents and entrepreneurship.

[91]The Preamble to the Marrakesh Agreement Establishing the WTO, delivers two main purposes of the WTO, which is (i) the reduction of tariffs and other barriers to trade; and the (ii) elimination of discriminatory treatment in international trade.

[92] See Asif H. Qureshi, "Trade Related Aspects Of International Taxation: A New WTO Code of Conduct", *Journal of World Trade,* vol.36, no.2, 1996, pp.161-92.

excise, turnover, etc.[93] Primarily, when goods are imported they are subject to customs duties or other financial burdens similar to customs duties. The Most-Favoured-Nation clause[94] under Article I defines that every nation is required to accord the benefits or exemptions that it grants to any product from any other country to like products from all the other member states.[95]

As per the principle of reciprocity member states are required to enter regularly into negotiations on possible concessions regarding customs duties.[96] Article III of the GATT requires that whenever a foreign product crosses the border, it should be subjected to the tax regime of the member state and that the member state shall not accord any favour to its local products[97]. Article I and III of the GATT deals with "taxes applied to like domestic products." Moreover,

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[93] As per footnote 58 of the Agreement on Subsidies and Countervailing Duties, "indirect taxes" would be defined as sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges:

[94]There are two forms of nondiscrimination namely, Most-Favoured Nation and National Treatment. The MFN treatment requires that every nation must give equal treatment to economic transactions originating in, or destined for, other countries entitled to the benefit of this treatment. National treatment requires a nation to treat equally every goods, services, persons, etc., within its borders, in the same manner in which it treats its own nationals.

[95] Under Article I (1) of the GATT, "all GATT/WTO members undertake commitments in which they are entitled to receive the MFN treatment given by any member-or to put it the other way round, they are entitled not to be discriminated against. This MFN or nondiscrimination, obligation applies to customs duties and charges of any kind connected with importing and exporting, as well as to internal taxes and charges and to all the rules by which such duties, taxes ands charges are applied. Exception to this rule is found in Article XXIV which permits member state of customs union and free trade areas to give more favourable treatment to imports from one another, and a 1979 understanding which permits preferences to and among developing countries", see John Croome, *Guide to the Uruguay Round Agreements* (Kluwer Law International, WTO, Geneva, 1999).

[96] Article II (1) (b) of the GATT states; that
"The products described in Part I of the Schedule relating to contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territories to which the schedule relates, and subject to the terms, conditions or qualifications set forth in that schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that due."

[97] In Article III of the GATT, it is contemplated that foreign products may not be subjected to higher taxes than the local products of the same kind and even if they are not like products they may not be subject to higher taxes for the sole reason that they compete with the domestic products. See Wolfgang Schon, "World Trade Organization Law and Tax Law", *Bulletin for International Fiscal Documentation*, vol. 58, no.7, 2004, pp.283-96.

Article XVI deals with the prohibition of subsidies and also gives importance to export subsidies.[98]

Both international trade law and BTTs have some similarity in them.[99] For instance BTTs deal with direct taxes, like income tax, wealth tax and inheritance tax, while GATT deals with indirect taxes and customs duties. Therefore, it is evident that main focus of the BTTs is on the economic actors and the residence or nationality clause is attributable to individual taxpayer and companies while applying non-discrimination principle. Differing from this criterion, nondiscrimination clause, MFN clause and the subsidy prohibitions[100] under the GATT and the GATS system apply to products and services. Presently, under the trade law, international trade consists both of intangible goods as well as the services (services were not a subject-matter of international trade).[101]

In addition to it, tax treaties are intended to facilitate and eliminate tax obstacles to international trade and international investment and not to make cross border trade more complicated. Thus, there are viewpoints that tax treaties do not have inborn tendency to be inconsistent with the GATT.[102] Therefore, the

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[98]The GATT 1947 did not contain any substantive international obligation against certain kind of subsidies (export subsidies). Only in 1955 an amendment was made to include such a provision. See John H. Jackson, *The Jurisprudence of GATT and the WTO: Insights on Treaty law and Economic Relations* (Cambridge: Cambridge University Press, 2000), at. 94.

[99] See Reuven Avi-Yonah., "Treating Tax Issues through Trade Regimes" *Brooklyn Journal of International Law* , Vol. 26, 2001, at p. 1683. See Asif H. Qureshi, n.78 at p. 165 as he argues on the interface between international trade and taxation based on the theory of comparative advantage, emphasizing that domestic system of taxation needs to be regulated to have maximum international allocative efficiency.

[100] See Article XVI of the GATT and XVI of the GATS.

[101] See Jackson, n. 98, at pp. 190-91.

[102] Alvin C. Warren Jr., "Income Tax Discrimination Against International Commerce," *Tax Law Review*, Vol. 54, 2001, at p.131; see also, footnote 59 to the Subsidies Agreement, which reads thus;
"The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that the prices for the goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any member may draw the attention of another Member to administrative or other practices which may contravene this principle and which results in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing

three main principles, which have relevance in taxation matters under the gamut of international trade law, are most-favoured-nation treatment, nondiscrimination clause and prohibition on subsidies.

Most of the international transactions occur between related entities[103], the physical presence of an entity though a requirement, earlier, is now not a necessary factor for proving the conduct of business[104] especially in relation to services in this digitalized world.[105] Many investors invest outside their country of residence, and substantial investments in corporations come form outside the entity's supposed country of residence. Tax havens create a vital threat to tax revenues and to the equity and neutrality of non-tax havens countries.[106]

The nexus between taxation and international trade law reveals that taxation is a matter that has high significance in trade related matters and affirms that tax treaties are highly important when it comes to determination of a host country by the foreign investors.

Therefore, it becomes essential in these circumstances to examine the initiatives taken by the OECD which is contended to be against the general principles of trade law. One must also note the period during which such moves and measures were taken by the OECD to curb such adverse tax

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bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultatior created in the preceding sentence.

Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign source income earned by its enterprises or the enterprises of another Member."

[103] For example, the existence of various laws relating to the Transnational Corporations including the issues relating to the transfer pricing shows that they trade among themselves, ie., related entities.

[104] A close perusal of Article 5 on Permanent Establishment and Article 9 on Associated Enterprises of most of the Indian Bilateral Tax Treaties and The UN MTC Proves that there is more emphasis on accepting any business connection as a permanent establishment, which adds to the above stated fact that "physical presence may no longer be required for the conduct of business".

[105]See Nandan Kamath., *Law Relating to Computers, Internet and E-Commerce,* (New Delhi: Universal Law Publishing company, 2001).

[106] See Charles E. McLure, Jr., "Globalization, Tax Rules and National Sovereignty" *Bulletin of international Fiscal Documentation,* Vol. 55, No. 8, 2001, pp. 328-40, at p. 334.

competition (that is, from 1995 onwards). For this purpose we now move on to the initiatives taken by the OECD during the last decade that is from 1995 (since the establishment of the WTO regime).

2. 6. 3. Compatibility Between OECD and WTO on double Taxation.

It is pertinent to note the initiative taken by the OECD with respect to shaping International Tax Law, specifically on the issue of double taxation.[107] The OECD Ministerial Communiqué granted a mandate on 1996 and prepared a report in 1998 on Harmful Tax Competition, which branded thirty-five countries[108] as tax havens[109] and forty-seven countries[110] as preferential tax regimes.[111] Such countries were required to sign a memorandum of understanding stating that they would make their laws compatible with the

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[107] See the Report of the OECD *Harmful Tax Competition: An Emerging Global Issue* (Paris: 1998), Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices (Paris: 2000),, Also available at http://www.oecd.org/daf/fa/harm_tax/Report_En.pdf.

[108]The 35 countries were Andorra, Isle of Man, Jersey, Gibraltar, Guernsey, Leichenstein, Monaco, Liberia, Seychelles, Antigua and Barbuda, Anguilla, Aruba, Bahamas, Barbados, British Virginia Islands, Belize, Dominica, Grenada, Montserrat, Netherlands, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos, US Virgin Islands, Cook Islands, Marshall Islands, Maldives, Nauru, Niue, Samoa, Tonga, Vanuatu, Bahrain.

[109] Tax havens means- countries; which have no/only nominal taxes, that lack effective exchange of information', which lack transparency and firms registered in these tax havens tend to have no substantial activity in the jurisdiction. On the other hand there is an argument that one of the main reasons have been the high tax rates and strict regulations in the developed countries, which had prompted the corporations and individuals staying there to invest in a developing country where they have more favourable investment climate.

[110] The OECD member countries identified as having harmful preferential tax regimes are: Australia, Belgium, Canada, Finland, Germany, Greece, Hungary, Iceland, Italy, Ireland, Korea, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and United States. See Javier G. Salinas., "The OECD Tax competition initiative: a critique of its merits in the global marketplace", *Houston Journal of International Law,* Vol. 25, No. 3, 2003, at. pp. 531-61, p. 547

[111]A Harmful tax practice is defined as any country that: (1) has no effective exchange of information, (2) lacks transparency, (3) has no substantial activities or ring fencing from domestic activities, and (4) simultaneously offers low, non-existent, or nominal tax rates; see generally Jeffrey Owens, Promoting Fair Tax Competition, (2000),at http://www.oecd.org/daf/fa/harm_tax/PromotingFairTaxComp.pdf. The 1998 OECD Report on harmful tax practices clearly distinguishes between tax haven and harmful preferential tax regimes. Tax havens are jurisdictions which have the ability to finance their public services with no or nominal income taxes and are used by nonresidents to escape tax in their country of residence, whereas a harmful preferential tax regimes would raise sufficient amount of revenue through its income tax, while it has the characteristics of a harmful tax competition.

conditions stipulated by the OECD and any default on their part to comply with the same, would result in declaring them as uncooperative jurisdictions.[112] Therefore these countries[113] had to make an advance commitment stating that they would fulfill their obligations on or before 31st July 2001, failing which defensive measures can be imposed on them.[114] The OECD had proposed some punitive sanctions or defensive measures against these uncooperative jurisdictions. The issue remains as to why a country should be targeted solely for the reason that their tax rates are low, as power of a state on such matters fall within its absolute sovereignty. One of the queries,[115] that was posed by various countries was whether OECD was the proper authority to issue such statements and term certain countries as uncooperative jurisdictions. The question put forth by the countries was whether their categorization as uncooperative jurisdictions and the intention to impose defensive measures by the OECD, is against the principles of WTO wherein the emphasis is on nondiscrimination and most

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[112] Such compliance was required to be done before 31st July, 2001. The guidelines on Harmful Tax Practices incorporate a "standstill provision" and a "roll back provision". Under the standstill provision the Member countries are to refrain from: adopting new measures and extending the scope of or strengthening existing measures that constitute harmful tax practices. Under the roll back provision the harmful features of these preferential regimes must be eliminated by April 2003.

[113] There were six countries which had committed to "eliminate their harmful tax practices," they are Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino. Bermuda and Cayman Islands, which were British Overseas Territories, had considerable pressure from London to sign the Commitment letters.

[114] At the meeting of the Joint Working Group in Paris (2nd March 2001), the targeted jurisdictions unanimously offered the following offered the following three things to the OECD in writing;
i) To sign a letter of commitment to the principles of nondiscrimination, transparency and effective exchange of information as an entitlement to join the OECD's Global Tax Forum and its working groups so as to contribute to the development of principles and standards applicable to OECD and non-OECD jurisdictions,
ii) To complete a plan for implementing agreed principles by 31st July 2001, and
iii) To implement the undertakings of the agreed plan by 31st December 2005. etc.. as quoted in Ronald Sanders, "The Fight against Fiscal Sovereignty: The OECD and Small Jurisdictions" *The Round Table: The Commonwealth Journal Of International Affairs*, Number 365, July, 2002, London. Also available at http://www.oecd.org/media/MOUletter20nov.pdf.

[115] The questions were:-
a) Should 41 jurisdictions around the world accept that the OECD has the right or authority to set itself up to make tax rulings which they expect nonmembers to follow?
b) By doing this, would these 41 jurisdictions, targeted by the OECD as 'tax havens', not be opening floodgates to a raft of other demands by an organization with no international authority except the coercive power of its member states?

favoured nation principle. This would mean that a nation or the products exported by it should not be discriminated in any way, which adversely affects that nation. Therefore, such defensive measures would be violating the general principles of the international trade law.

2. 6. 3. i. International Tax Competition

"Tax competition has become a fact of life for many countries and the effect of such a competition is or will be a reduction in tax revenue for many countries and a forced change in the structure of their tax system."[116]

The types of international tax competition are, seen as imposition of low tax rates to attract foreign investment and special holding company schemes to allow international investment to flow through these companies without taxation.[117] The OECD report defines the harmful preferential elements as those with no/low effective tax rates, 'ring-fencing' of domestic and off shore regimes, lack of transparency and lack of effective exchange of information. International tax competition has also been seen as a counterpart to "unfair trade practices" under trade law.[118] So far thirty-five jurisdictions have been considered as tax havens, which includes Mauritius too. The report had faced lots of objections from OECD countries itself.[119]

International tax competition, one of the prominent tax issue, was tried to be resolved by both European Union and the OECD. These two organizations differ in their content as the EU intends to apply such measures only to its

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[116] See Tanzi, n. 85, at p. 341

[117] See Sven-Olof Lodin, "What Ought To Be Taxed And What Can Be Taxed: A New International Dilemma", *Bulletin for International Fiscal Documentation* Vol. 54, No. 5, 2000, p. 210, at p.213 - 14.

[118] See Jeffrey Owens., "Taxation Within a Context of Economic Globalization", *Bulletin of International Fiscal Documentation*, vol.52, no.7, 2003, pp. 290-96, at p. 292.

[119] Two OECD countries Luxembourg and Switzerland that are the biggest competitors with the Caribbean jurisdictions for the offshore banking services, abstained from voting on its passage in the OECD Council.
Luxembourg stated that it "does not share the report's implicit belief that bank secrecy is necessarily a source of harmful tax competition."
On the other hand, *Switzerland* stated, "the report presents the fact that tax rates in one country than another as a criterion of identifying harmful preferential tax regimes. This results in unacceptable protection of countries with high levels of taxation, which is contrary to the economic philosophy of the OECD." See Harmful Tax Competition, n. 107, at pp.73-77.

members while OECD extends its authority to non-members too. The EU member states agreed upon '*The Code of Conduct on Business Taxation*'[120] in which it identified harmful tax competition "to be a beneficial tax treatment that is limited to certain activities or groups of taxpayers, such as special industry, foreign investors, companies within a special region, and any other kinds of ring fencing, as well as administrative practices, such as options for companies to get special treatment through negotiations or special rulings."[121]

Parallel to it, the OECD also dealt with the same. Its concern is that its member states will lose investors who would otherwise be subject to their high taxation. Once these investors are taxed, small and developing countries would be deprived from economic development through their tax structure and systems.[122] It is necessary to look into the concept of tax haven and the arguments of various countries that objected vehemently to the OECD's report.

2. 6. 3. ii. The emergence of tax haven countries

The OECD 2000 report made efforts to remove harmful tax practices along with the motive to fight the tax havens.[123] Certain countries were listed or blacklisted as tax havens. This list omitted those countries which had made 'advance commitments' to eliminate their harmful tax practices. The OECD Council recommended for initiating an active dialogue with these uncooperative jurisdictions. The impact of such blacklisting would be that some reputed companies might relocate their activities in these blacklisted countries.[124] The Caribbean countries argued fervently that listing of tax

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[120] See Sven-Olof Lodin, "International Tax Issues in a Rapidly Changing World", *Bulletin for International Fiscal Documentation*, vol.55, no.1, 2001, pp. 2-7.

[121] Ibid, at. p. 3

[122] See Sanders, n. 114, at. p. 13

[123] The OECD Report of 2000, at. p. 15.

[124] See Jeffrey Owens, Towards world tax cooperation, OECD OBSERVER, Oct. 19, 2000, available at http://www.oecdobserver.org., as cited in Akiko Hishikawa, "The Death of Tax Havens ?", *Boston College International and Comparative Law Review*, vol.25, no.373, pp.389-417.

regimes as harmful is a matter of sovereignty and should not be ordered by 'external agencies or countries'. Also, they contended that the United Nations would be the appropriate forum to achieve the elimination of harmful tax practices rather than by imposing direct pressure of the OECD.

2. 6. 4. E-commerce[125] and advancement of technology and its impact on the concept of double taxation.

One of the important developments after the beginning of e-commerce is with respect to the change that occurred in the concept of permanent establishment and business profits.[126] Due to the increasing pace of e-commerce revolution, one can find that the physical presence of a permanent establishment that was a necessary condition to determine the residence of a company earlier is now a vanishing point since the sprouting up of the Internet. Post Internet revolution period (since 1995 onwards) reveals that the presence of a website itself would constitute a permanent establishment. In a world of cyberspace, the traditional concepts like taxation of income based on geographical location, has become irrelevant. There was a general discussion as to whether websites would constitute a permanent establishment, answering which the OECD declared that only at certain circumstances an Internet Service Provider (hereafter referred to as ISP) be treated as a permanent establishment,

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[125] See generally, Sven-Olof Lodin, "International Tax Issues in a Rapidly Changing World", *Bulletin of International Fiscal Documentation*, vol.55, no.1, 2001, pp. 2-7; see Sven-Olof Lodin, "What Ought To Be Taxed And What Can Be Taxed: A New International Dilemma", *Bulletin For International Fiscal Documentation* vol.54, no.5, 2000, p. 210, at p. 213-214; Charles E. Mclure Jr., "Globalization, Tax Rules and National Sovereignty," *Bulletin of International Fiscal Documentation*, vol.55, no.8, 2001, pp. 328-41; Jeffrey Owens, "Taxation Within a Context of Economic Globalization", *Bulletin of International Fiscal Documentation*, vol.52 ,no.7, 2003, pp. 290-6; Wolfgang Schon, "World Trade Organization Law and Tax Law", *Bulletin for International Fiscal Documentation*, vol.58, no.7, 2004, pp.283-96.

[126] Three technical issues which were addressed by the OECD in its report on electronic commerce were; (i) whether electronic delivery of software, music, video or other digital products would be business profits or royalties; (ii) whether electronic commerce transactions involving the provision of technical fee would amount to business profits or technical fees; (iii) whether electronic commerce transaction involving payments for the use of industrial, commercial or scientific equipment is services or transfer of property. See the Report of the OECD Technical Advisory Group on the Characterisation of Electronic Commerce Revenue for the International Income Tax Purposes, as cited in D. P. Mittal, n. 56, at. Annex 5.1.

that is, when a dependent agent of another enterprise may constitute a permanent establishment.

Taxing the income on royalties has been an issue ever since globalisation. The OECD in its commentary to Article 12 of the OECD MTC gives out that delivery of the computer software programmes should be treated as the same as the physical delivery of the same programme, because the method of transferring the computer programme to the transferee is not relevant. Based on this argument the Report laid down that computer software programmes yield to a consumer is business profits and not royalties. In the light of these substantial changes, it becomes pertinent to note that earlier a state could tax a permanent establishment based on its residence but after Internet revolution, a state cannot determine its jurisdiction over the permanent establishment because ISP's location cannot be determined. Hence, the doubt remains as to which state has the jurisdiction to tax the income of the permanent establishment (which is an ISP). Therefore, it is an affirming that the concept of national sovereignty over the taxation matters is getting eroded.

2. 7. Conclusion.

In summary, the Purpose of tax treaties is to apply the -

- Provisions only to taxes on income and capital,
- Limit the double taxation of income,
- Create greater certainty for investors,
- Assure non-discrimination and
- Provide exchange of information between tax authorities that can be used to prevent tax evasion.

The existing two framework MTCs are the OECD and UN MTC. These conventions stand binding among nations because when they negotiate on a BTT they refer to either of them and adopt the principles and definitions incorporated in it. By having a cursory glance at the large number of bilateral tax treaties signed by different nations, it can be inferred that both OECD and UN MTCs though are provide only a framework, their high influence have been significant in determining the tax laws of nations on double taxation avoidance.

It has been argued that at the multilateral level we should have a uniform agreement on avoidance of double taxation, but BTTs should be preferred over it since states can retain their right to tax through negotiations. It would benefit the developing countries in upholding their interests at the negotiations.

BTTs play a vital role in the determination of host countries by the investors, since they prefer to invest in those countries with which their home country has a BTT. These treaties are in a way a motivating factor for the investors. The reason could be attributed to the fact that they incorporate in them provisions with respect to permanent establishment, associated enterprises, business profits, dividends, capital gains etc. among other important provisions. While the BTTs play a crucial role the actual tax rates are determined in accordance with the domestic tax law of a country.

Further, they incorporate certain methods of international cooperation like Exchange of Information and Assistance in Collection and Mutual Agreement Procedure. It cannot be denied that there is a strong nexus between international trade and avoidance of double taxation, since every goods, product or person; when crosses international borders is taxed based on its relationship with that country. Again, globalization has played a pivotal role in increasing the trade and investment.

Apart from that, the emergence of tax haven countries and harmful tax practices including tax competition affirms that there has been a paradigm shift in the choice of investment in a country from certain developed countries to developing countries.

Chapter III

Indian Tax Treaties: Salient Features

CHAPTER III

INDIAN TAX TREATIES: SALIENT FEATURES

3. 1. New Industrial Policy, 1991 and India's Tax Structure

On a comparative analysis of the current tax structure of India, with the tax structure before 1990s, it is hard to deny the fact that it has undergone radical changes. The importance can be attached to the industrial structure established in India then. Before the announcement of the New Industrial Policy (hereafter referred to as NIP), the companies had restrictions for the entry and establishment in India. The NIP was with certain objectives like -

- Increasing the productivity of competition in the domestic market;
- Reduction of production costs; and,
- Deregulation of domestic industrial sector, etc.[1]

The NIP had opened the annals of Indian economy to the outside world, especially to the foreign investors due to India's heavy financial crisis. The noteworthy change introduced then was on the entry and growth barriers, which were removed by restructuring the Monopolies and Restrictive Trade Practices Act, 1969, and Foreign Exchange Regulation Act, 1973.[2] These legislations were amended to remove the pre entry restrictions of a foreign company.[3] The

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[1]This was announced on 24th July 1991.

[2] Sections 26(7), 28, 29 and 31 of the Foreign Exchange Regulation Act, 1973(herein after referred to as FERA), had been revised in the light of the New Industrial Policy. The FERA companies were given the advantage of nondiscrimination principle as they were treated equally when compared to domestic industry. A FERA company is a company, which has foreign equity of more than 40%. After the revision, the FERA companies have been given the freedom to borrow money and accept deposits in India. The FERA is now changed to the Foreign Exchange Management Act, 1999. As per Section 592 of the Indian Companies Act, read with 6(6) of the Foreign Exchange Management Act, 1999, no person resident outside India shall without the approval or knowledge of Reserve Bank of India may establish in India as a branch or liaison office or project office or any other place of business.

[3]The pre-entry restrictions were; to get the prior approval for a new undertaking, expansion, amalgamations, mergers, takeovers and appointment of directors. According to the amendment, no undertakings need to be registered as an MRTP undertaking.

main intention of the government by opening up the industry was to emphasis on the advantages of the technology transfer, marketing expertise and the technical and managerial know-how vis-à-vis promoting foreign investment. Apart from emphasizing the need to promote foreign investment the necessity to have a dynamic relationship between domestic and foreign industry, was stressed.[4] As a measure there was some relaxation for establishing new industry.[5] Further, a scrutiny of the tax treaties entered into by India after 1991 reveals that 42[6] BTTs were concluded, which means that after the coming into effect of the NIP there have been substantial increase in the number of bilateral tax treaties and bilateral investment promotion agreements signed by India. This shows that the liberalization policy has been a real booster for the foreign investors in India, as tax treaties gave a legal certainty for them to invest.[7]

In the policy, one can find reference to foreign investment and foreign collaboration, along with certain other proposals on measures to attract foreign investment. The policy was divided into these categories, namely; (i) Industrial Licensing, (ii) Foreign Investment, (iii) Foreign Technology Agreements, (iv)

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[4] Paragraph 24 of the New Industrial Policy reads thus; "While freeing Indian industry from official controls, opportunities for promoting foreign investments in India should also be fully exploited. In view of the significant development of India's industrial economy in the last 40 years, the general resilience, size and level of sophistication achieved, and the significant changes that have also taken place in the world industrial economy, the relationship between domestic and foreign industry needs to be much more dynamic than it has been in the past in terms of both technology and investment. Foreign investment would bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for the promotion of exports. This is particularly necessary in the changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore welcome foreign investment which is in the interest of the country's industrial development." See Rajiv Jain, *Guide on Foreign Collaborations, Policies and Procedures*, (New Delhi: India Investment Publication, 2003).

[5] Up to 51 % foreign equity would be given for a foreign company to establish in high priority industries in India; the RBI would monitor the payment of dividends etc., so as to ensure that the outflow on account of dividend payments are balanced by export earnings over a period of time;

[6] Before 1991, India had signed only 28 Bilateral Tax Treaties. The new treaty with Malaysia was also concluded after liberalization policy and the establishment of WTO.

[7] See Chanchal Chopra, *Foreign Investment in India: Liberalization and WTO – The Emerging Scenario,* (New Delhi: Deep and Deep publications Ltd.), 2004. India's top investors are USA, Mauritius, UK, Japan, South Korea, Germany, Malaysia, Netherlands, Australia, France, Singapore, Thailand and Italy.

Public Sector Policy and (v) Monopolies and Restrictive Trade Practices Act. Certain set of policies was also announced for the small and tiny sectors.

Another significance is the promotion of the Foreign Institutional Investors (hereafter referred to as FIIs).[8] They are the primary source of portfolio investment in India. The intention of such guidelines was to open the stock markets to direct participation by the FIIs[9]. The liberalization policies and programmes have also triggered for an appropriate portfolio investment. Yet they are branded across the world as notoriously fickle,[10] as they get away with not paying taxes in the country, by routing the transactions through countries in which they are exempted from taxation on the basis of the BTTs. Subsequently, BITs also flourished in India only after 1991. Both BTT and BIPAs are complementary in nature as they intend to promote foreign investment. At this point it is highly relevant to examine the relationship between tax treaties and investment agreements in order to get a better understanding as to why tax matters were excluded from the purview of investment agreements and how far India's bilateral investment and tax treaties are influenced by the liberalisation policy of India.

3. 2. Interface Between Investment Agreements and Tax Treaties.

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[8] Section 115 AD of the Indian Income Tax Act defines Financial Institutional Investors. Later on during September 1992, broad guidelines were issued for the foreign institutional investors. These FIIs play a pivotal role in the host country as they have the benefit of concessional tax treatment, which means that flat tax rate of 20% is applied to the gross interest income and 10% to the long-term capital gains arising from the sale of shares held for one year or more. The concessional rate of tax on the long-term capital gains is an incentive for the FIIs to conduct their business and investment for a longer period, see http://www.sebi.com.

[9] In November 1995, the Securities Exchange Board of India (SEBI) brought into effect the SEBI (Foreign Institutional Investors) Regulations, 1995. These regulations required the FIIs to register with the SEBI and to obtain approval from the Reserve Bank of India (RBI) under the FERA in order to enable them to buy and sell securities, to open foreign currency and rupee bank accounts and to remit and repatriate funds.

[10] See Chopra, n. 7, at p. 222. They are branded as fickle because any slightest whiff of danger would be enough for them to leave the host country, as examined in the recent East Asian Crisis.

There are many similarities between Investment and Taxation agreements.[11] Large number of the Bilateral Investment Treaties (BITs) exempt taxation matters as an exception to the MFN and nondiscrimination principles. One of the reasons could be that if a contracting state provides a favourable tax treatment to investment by investors of another country then it should give the same treatment to investment by investors of third country with which it has a Bilateral Investment Treaties. There are other reasons too, which can be summarized thus;

- States prefer to address international taxation matters in a separate treaty, which exclusively deals with it, for maintaining maximum fiscal sovereignty.
- Such an exception would allow a country to conclude a tax treaty with another country granting special tax concessions, without bothering to grant same treatment by virtue of MFN provision in the BITs.
- The complexities of tax matters may become unsuitable for the inclusion in the kind of standardized provisions that are typical of BITs.[12]

The United States Model on BIT[13] and the Indian Model on BIT[14] refers to such an exception in relation to the MFN treatment. There was a proposal to

[11] The similarities are that they both are intended to facilitate and encourage trade between countries on the assumption that global welfare is enhanced, also, they contain rules which require certain kinds of advantages and prohibiting certain forms of discrimination against the treaty partner. Further, they contain rules and mechanisms for dispute settlement.

[12] United Nations Conference on Trade and Development (1999), *International Taxation.* UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations), United Nations Publications, Sales No. E. 99. 11. D. p. 36.

[13] Article XIII of the US Model on BIT reads thus;
"1. No provision of this Treaty shall impose obligations with respect to tax matters, except that: (a) Articles III, IX and X will apply with respect to expropriation; and (b) Article IX will apply with respect to an investment agreement or an investment authorization.
2. A national or company, that asserts in an investment dispute that a tax matter involves an expropriation, may submit that dispute to arbitration pursuant to Article IX (3) only if:
(a) The national or company concerned has first referred to the competent tax authorities of both Parties the issue of whether the tax matter involves an expropriation; and (b) the competent tax authorities have not both determined, within nine months from the time the national or company referred the issue, that the matter does not involve an expropriation."

[14] Article 4(3) of the Indian Model of BIT;
"(3) The provisions of paragraphs (1) and (2) above shall not be construed so as to oblige one Contracting Party, to extend to the investors of the other the benefit of any treatment, preference or privilege resulting from:

include an Article in the GATT dealing with double taxation. Also there was an attempt to include the taxation matter in the Multilateral Agreement on Investment,[15] but such an inclusion is not necessary since it is difficult to agree on a multilateral agreement on taxation matters.[16] Further, it would be difficult for nations to compromise on matters in which they have absolute sovereignty.

Though the BITs and BTTs are complementary in nature, they differ in their purpose they serve. While BITs are intended to promote and protect investment, for generating revenues, the BTTs provides for the remedies in case of revenue allocation issues. The other important factor is that the investment agreements do not deal with tax issues. Tax treaties are major determinants of foreign investment because:-

- From the investing firms or investors perspectives the binding nature of the tax treaty as an international agreement contributes to secure a basis for investment.
- The existence of a tax treaty with the investor's country, give them an assurance that these countries have a firm and strong background of domestic tax laws.
- On the basis of a tax treaty it can be assured that whenever there arises a dispute the objective of avoiding double taxation would be through mutual agreement procedure and will also adopt internationally accepted standard for the issues of transfer pricing. Therefore, the numbers of tax treaties signed by states are more than the number of BITs.

(a) Any existing or future customs unions or similar international agreement to which it is or may become a party, or
(b) Any matter pertaining wholly or mainly to taxation."

[15] OECD, *A Multilateral Agreement on Investment, Report by the Committee on International Investment and Multinational Enterprises (CIME) and the Committee on Capital Movements and Invisible Transactions (CMIT),* Paris 1995. the draft text of the MAI is also available at http://www.oecd.org/daf/cmis/mai/negtext.htm.

[16] This has already been explained in the previous chapter. The reason that is emphasized here is that the developing countries and the countries in transition needs some space of their own, in such negotiations. Further, as most of the country's tax system is different, it is difficult to reach a consensus. Again, MAI was negotiated under the auspices of OECD, which is an organization of developed countries. Therefore, it is necessary that nations should have their own freedom to decide concessions that they would give under their tax treaties. See Daniel D. Bradlow and Alfred Escher, ed., *Legal Aspects of Foreign Direct Investment*, (The Hague: Kluwer Law International, 1999).

India has so far signed forty-seven BITs[17] and seventy comprehensive BTTs. Compared to India's BTTs very few BIPAs have been signed.[18] One of the reasons could be India's liberalisation policy, which came into effect only in 1991, and therefore we have the BIPAs signed only after 1991. These BIPAs are signed to overcome the fears of confiscation and to accelerate the flow of foreign direct investment.

After analyzing the influence of NIP of India in attracting foreign investment into India and also the enactment of subsequent BIPAs shows that promoting foreign investment increases the revenue. When such investment is increasing or rather promoted then obviously the issues like taxing them appropriately arises. Further, in order to give the foreign investor a certainty as to taxation of his income (be it any income like business income or investment income) in accordance with the law we need to make the laws appropriate. Therefore, in this regard the role played by the BTTs cannot be underestimated. Hence, we need to analyze the salient features of the Indian BTTs.

3. 3. Indian Bilateral Tax Treaties: Its Salient Features

3. 3. 1. Basic Facts

India has so far signed eighty-five[19] BTTs inclusive of both limited and comprehensive agreements.[20] At the regional level India has called for a

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[17] Countries with whom India has a BIPA are Australia, Austria, Argentina, UK, Russian Federation, Germany, Malaysia, Denmark, Netherlands, Italy, Israel, South Korea, Poland, Czech Republic, Kazaks tan, Sri Lanka, Vietnam, Oman, Switzerland, Egypt, Kyrgyz Stan, France, Spain, Belgium, Romania, Mauritius, Bulgaria, Morocco, Qatar, Uzbekistan, Philippines, Portugal, Sweden, Thailand, Laos, Mongolia, Croatia, Kuwait, Finland, Taiwan, Ukraine, Tajikistan, Belarus, Indonesia, Cyprus, Yemen and OPIC (Overseas Private Investment Corporation is a designated agency of USA).

[18] India has a model of BIPA too. One of the means to promote foreign investment keep the withholding tax rates if kept low would attract foreign investment and that would act as a source of encouragement for other countries to enter into agreement and bring in foreign investment. For example the India-Germany Tax Treaty, which has low withholding rates of tax, therefore it is able to attract foreign investment from Germany as well as other OECD countries. See Har Govind, "Financial Structures For No-residents in India", *Bulletin of International Fiscal Documentation*, vol.51, no.1, 1997, p.447-54.

[19] India has 70 Comprehensive Agreements with countries like Algeria, Armenia, Australia, Austria, Bangladesh, Belarus, Belgium, Brazil, Bulgaria, Canada, China, Cyprus, Czech Republic, Czechoslovakia, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Indonesia, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Korea, Kyrgyz Stan, Libya, Malaysia, Malta, Mauritius, Mongolia, Morocco, Namibia, Nepal, Netherlands, New Zealand,

multilateral tax treaty for the South Asia Association for Regional Cooperation (SAARC) region, India has asked the member countries to deepen and widen the pace of their economic integration.[21] India has signed BTTs with four South Asian Association of Regional Cooperation (SAARC) countries[22] in which India's BTT with Pakistan is a limited agreement and not a comprehensive one. Further, India has entered into tax treaties with six ASEAN (Association of South East Asian Nations) countries too.[23] But there has been no move to enter into a multilateral tax treaty under the auspices of ASEAN.

Generally, India follows two patterns of agreements depending upon the other contracting State, *i.e.* a model for agreement with developed countries and another model agreement with developing countries. Though on an overview,

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Norway, Oman, Philippines, Poland, Portugal, Qatar, Romania, Russian Federation, Sierra Leone, Singapore, Slovak Republic, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Syrian Arab Republic, Tanzania, Thailand, Trinidad and Tobago, Turkey, Turkmenistan, Ukraine, USSR, UAE, UK, USA, Uzbekistan, Vietnam, Zambia.
India's has signed 15 Limited Agreements with Afghanistan, Bulgaria, Czechoslovakia, Ethiopia, German Democratic Republic, Iran, Kuwait, Lebanon, Oman, Pakistan, Saudi Arabia, USSR, UK, UAE, USA.

[20] Limited Agreement means those agreements, which confine to an agreement, which refers to shipping and to air transport, or to estates, inheritance and gifts. Comprehensive Agreements relates to taxes on income, capital gains and capital. These agreements affirm that the taxpayer in both the country should be treated, taxed equally on an equitable basis. India's comprehensive tax treaties deal with the rules for computation and allocation between it and the other Contracting States, the income that arises from activities like business, independent personal services, dependent personal services, from assets such as dividends, interest, royalties, rents, income arising out of capital gains, etc.

[21] Available at http://www.southasianmedia.net/index_story.cfm?id=98312&category=Frontend&Country=MAIN, and also http://www.deccanherald.com/deccanherald/mar242004/n1.asp last visited on July 5, 2005. Addressing the first meeting of the SAARC Inter-governmental Expert Group on Investment, Arbitration and Avoidance of double taxation here, Foreign Secretary Shashank said such a tax treaty would offer greater and more comprehensive protection to investors. It would also provide relative legal certainty as regards their tax status. Similarly, a mechanism for settlement of investment disputes at the regional-level would serve as one of the means of attracting foreign investment in the SAARC region.

[22] Total number of SAARC countries is seven, namely, (i) Bangladesh, (ii) Bhutan, (iii) Maldives, (iv) Nepal, (v) Pakistan, (vi) Sri Lanka and (vii) India. Among which India has signed comprehensive BTTs with Bangladesh, Nepal, Sri Lanka and limited agreements with Pakistan.

[23] ASEAN countries are (i) Brunei, (ii) Cambodia, (iii) Indonesia, (iv) Laos, (v) Malaysia, (vi) Myanmar, (vii) Philippines, (viii) Singapore, (ix) Thailand, (x) Vietnam.
India has entered into tax treaties with (i) Indonesia, (ii) Malaysia, (iii) Philippines, (iv) Singapore, (v) Thailand, (vi) Vietnam.

the agreements appear to be same, they differ in contents and basic approach.[24] It is an undisputable fact that an agreement with a developed country is intended to attract foreign investment through certain tax incentives. In an agreement with a developing country a *quid pro quo* relationship is maintained. Each agreement differs from country to country depending upon their economic policies, technological advancement, economic and trade relations with the other Contracting States. Mauritius is an exception to this.[25] Before going into the details of the salient features of the Indian bilateral tax treaties we shall examine the relationship between tax treaties and Indian domestic laws like Income Tax Act, 1961 and Indian Companies Act, 1956.

3. 3. 2. Indian Domestic laws and BTTs.

Tax treaties are domestic legislations in itself, but with a difference as they lay down what to tax and how to tax an income, while Indian Income Tax Act, defines the tax rates. Tax treaties are a corpus of different tax laws, which includes income tax, wealth tax, gift tax etc subject to the agreement of both the contracting states. They are considered as mini legislations as they are read along with local taxation laws.

The Central Government derives its authority to enter into agreements with foreign countries based on Article 246(1)[26] read with Entry 14 of the List I of the Seventh Schedule[27] of the Constitution of India, 1950. The relevance of Article 265 of the Indian Constitution cannot be ruled out as it lays down that in

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[24]See generally, K Srinivasan, *Guide to Double Taxation Avoidance Agreements,* (New Delhi: Vidhi Foundation, 1992), at p. 37.

[25] Though the agreement was basically intended to have a quid pro quo relationship, due to the nature of tax laws in Mauritius vis-à-vis India's liberalization policies, Mauritius stands the second largest country which has the FDI in India.

[26] Article 246 (1) of the Constitution of India reads thus,
"Subject-matter of laws made by Parliament and by the Legislatures of States._ (1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the "Union List").

[27] Entry 14 of List I of the Seventh Schedule to the Constitution of India;
"Entering into Treaties and agreements with foreign countries and implementing of the treaties, agreements and Conventions with foreign countries."

relation to tax it shall be levied and collected under the authority of law. A BTT has dual nature; firstly, it is an international agreement since it is entered into between two sovereign states and secondly, it is a *lex specialis* since immediately after it entry into force, it becomes a domestic law.[28] Section 90[29] of the Indian Income Tax Act acquires relevance in the context of domestic incorporation requirements. This provision enumerates that the Central Government is empowered to enter into agreement with any country for the avoidance of double taxation of an income, which is taxed under either of the country's domestic tax laws. Along with this, the Central Government may by notification in the official gazette make provisions in order to implement the agreement[30]

Section 90 of the Indian Income Tax Act, 1961 was modeled on Section 49 A of the Indian Income Tax Act, 1922 which *inter alia* empowered the government to enter into double taxation agreements.[31] Therefore, section 90 is considered as the implementing provision of the tax treaties in India.

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[28] See Philip Baker, *Double Taxation Conventions- A Manual on the OECD Model Tax Convention on Income and on Capital*, (London: Sweet and Maxwell, 2001), p. E-1.

[29] Section 90 (1) of the Indian Income Tax Act, 1961, reads thus;
"Agreement with Foreign Countries: (1) The central government may enter into an agreement with the Government of any country outside India-

a) For the granting of relief in respect of income on which have been paid both income-tax under this Act and income- tax in that country, or
b) For the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or
c) For exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or
d) For the recovery of income – tax under this Act and under the corresponding law in force in that country, and may, by notification in the official gazette , make such provisions as may be necessary for implementing the agreement.

(2) Where the central government has entered into an agreement with the government of any country outside India under sub-section (1) for granting relief of tax, or, as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

[30] See H. P. Agarwal, *Business Collaboration With India Alongwith Texts of Double Taxation Treaties*, (New Delhi: Wadhwa and Co., 2001). 6th edn.

[31] See M. B. Rao, *Double Tax Treaties Between Developing & Developed Countries*, (New Delhi: Milind Publications Pvt. Ltd., 1983), at p. 149. It is an exception to Section 4 and 5 of the Indian Income Tax Act. Section 4 charges every person (as defined under section 2(31) with respect to his 'total income' is defined under section 5 of the Act.

There have been major changes (in 1976) to the Indian Income Tax Act, 1961, as a result we see that the BTT entered into between 1959-1976 follows almost the OECD MTC or a similar pattern. Inclusion of Section 44 D to the Act had changed the taxability of income of royalties and fee for technical services emphasizing that such income should have arisen in India, which means that the tax agreements prior to 1976 had a provision for limited right of taxation in respect of investment income in the country of source. Later on, the doctrine of attraction rule[32] was applied on incomes by way of interest, royalty and technical service fee. Hence, from 1980 onwards, India started following the UN MTC. Now we shall examine briefly the relationship between tax treaties and Indian Companies Act, 1956[33] as it is significant because they explain the kind of companies, the procedures for incorporation of foreign companies. According to India's domestic legislations a foreign company is the one, which is incorporated outside India and establishing a 'place of business' within India; and companies incorporated outside India and establishes a place of business within India and continues to have the same. The incorporation of a company is very essential to determine the residential status of the company[34].

In one of the important cases,[35] a mooted question was whether a company could be regarded as a resident in more than one country. The court

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[32]The doctrine of force of attraction means all income arising from all sources in country, where the foreign enterprise maintains a permanent establishment, is subject to tax in that country. Every profits that the enterprise earns outside the permanent establishment, would be subject to taxation as it attracts to itself all of the profits derived by the enterprise from the jurisdiction where it is located. This is based on the source principle.

[33] Part XI of the Indian Companies Act (Section 591-602), deals with the 'foreign companies.' The 'foreign companies' are more relevant since they are the beneficiaries of the India's liberalization policies, *inter alia*, the other factors like employment opportunities, improved standard of living, etc... The treaties refer to the Companies (Profits) Surtax Act, 1964 under Article 2, which states "Indian tax" to be both Income Tax Act, 1961 and the Companies (Profits) Surtax Act, 1964. Most of the bilateral tax treaties defines a company and enterprise[33] as,
"The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes under the taxation laws of the respective Contracting States;"

[34]Section 6(3) of the Indian Income Tax Act, defines the residential status of a company, which proclaims a company to be a resident in India; if it is an Indian company and during that year the control and management of its affairs is wholly in India.

[35] *Union of India* v. *Azadi Bachao Andolan* (2003) 263 ITR 706.

held that a foreign company is resident which is usually non-resident, but has the control and management of its affairs situate wholly in India, and therefore such foreign company could be regarded as resident in India. If the foreign company has to be away from claiming the residential status or wants to avoid the residential status being thrust upon it, it has to ensure that at least a part of the control and management of its affairs for the relevant accounting year is carried out from any place outside India, failing which the objective may not be achieved by it.

One cannot negate the fact that there is a close nexus between Indian bilateral tax treaties and Indian domestic laws because whenever there arises an issue of interpretation of any of the terminologies mentioned in the tax treaties the authorities will refer to the domestic laws of the India and the other contracting state. Therefore, now we shall discuss briefly about the salient features of the Indian tax treaties.

3. 3. 3. Scope and Applicability

States enter into BTTs and BIPAs for their development through an increase in investment and trade through other countries. BTTs include comprehensive tax treaties which covers all sources of income like, technological flow or capital or transfer of services and exchange (programmes for) of teachers, students, researchers, artists, etc[36]. As per Article 1 of the respective conventions namely, OECD and UN MTC, majority of the Indian BTT applies to persons who are residents of one or both Contracting States. Before determining the applicability of these conventions one has to establish whether an individual or an entity is a person and whether he can be taxed based on his residence, domicile, and place of management or similar criteria. If a resident of a third state takes the advantage of any tax treaty to which he is not a subject, then it is called 'treaty shopping'[37].

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[36] In short these provisions or characteristics are highly relevant to apply trade law especially the WTO rules for they both have a similar intention.

[37] One of the essential features of *treaty shopping* is the establishment of base companies in other states only for the purpose of enjoying the tax benefits of a particular treaty rules existing between the state and the third state. The consequences of treaty shopping to source country is

The definition of 'person', 'resident' etc need to be analyzed both in the light of the definition under the UN MTC and also under the Indian Income tax Act. A person (including an artificial legal entity) who is not a resident of either of the Contracting States will not fall within the purview of these treaties.[38]

3. 3. 4. Definition Clause

This section would attempt to define certain terms like Permanent Establishment, Business profits, Associated Enterprises and Capital Gains which are vital to tax treaties. It is important to study these concepts because they are the determining factors as far as foreign investors are concerned, for they explicitly mention whether these companies or their profits or income would fall within the said category and also determines under which heads of income they will be taxed. Along with this we shall attempt to analyse how it has been dealt in Indian bilateral tax treaties *viv-a-vis* UN and OECD MTC.

3. 3. 4. i. Permanent Establishment and Business Profits

Permanent establishments play an important role in business. When investing abroad, every business enterprise is confronted with the question of whether to set up a subsidiary or a permanent establishment. These decisions all have significant and severe tax implications. This concept means a fixed place of business through which the business of the enterprise is wholly or partly carried on. It could be place of management, a branch, an office, a factory, a

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very crucial as they incur loss of revenue by restricting the rate of withholding taxes and thereby they are deprived of their negotiation powers. This can be remedied by introducing anti shopping article in the tax treaties and strengthening the domestic legislation by prohibiting or restricting the use of its tax treaties for treaty shopping.

[38] Like any multinational Corporations, say X Company, which is incorporated in United States shall not come within the purview of India-Malta Agreement, though it does its business in both countries. The determining factors for a person to be termed a resident are his domicile, residence, place of management or other criteria as per the laws of the state which taxes them. For the definition of 'residence', see Article 4 of the UN Model. See also, *Mohsinally Alimohammed Rafik* (1945) 213 ITR 317 (AAR), *Dr. Rajnikant R. Bhatt* v. *CIT* (1996) 222 ITR 562 (AAR) and *Robert W. Smith's case* (1995) 212 ITR 275 (AAR).

workshop, etc.[39] The test for determining a permanent establishment is to examine

(i) Whether there is a fixed place of business,

(ii) Through which business is carried out, and

(iii) Whether carried out wholly or partly by the enterprise.

Income Tax Act, 1961 uses the term 'Business connection' in lieu of permanent establishment, with the same connotation. This term requires the business connection to have continuity between the business of the non-resident and activity in India.[40] The term business profits requires mention here since every business connection or permanent establishment's profits are subjected to tax. The three important factors for determining such liability of income in this regard, are:- (i) Residence, (ii) Source of income, and (iii) Permanent Establishment. Further, one has to prove that there is a 'substantial business connection' in order to compute the income that arise from the business profits. The court has very often interpreted the term 'may be taxed' in the other Contracting States to be conclusive stating that income shall be taxed only in the source country.[41]

India in its most of the BTTs follow the UN MTC by adopting same connotation for 'permanent establishment' including the limitation period for proving the continuity of such branch. India's Tax Treaties with SAARC countries (and certain ASEAN countries like Indonesia, Singapore and

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[39]Article 5 of most of the Indian BTT defines the concept 'Permanent Establishment.'

[40] A business connection involves a relation between a business carried on by a non-resident, who yields profits and gains and some activity in India which contributes directly or indirectly to the earning of those profits and gains. A business connection is established where a non-resident has either (1) a factory, (2) a branch or a (3) subsidiary company, or an agent. Definition of a 'business connection' was explained by the Supreme Court of India in *Commissioner of Income Tax* v. *R. D. Aggarwal & Co.* [1965] 56 ITR 20 (SC). See also, Section 9 (1) (i) of the income Tax Act, 1961; which reads thus;
"9 (1) The following incomes shall be deemed to accrue or arise in India-
(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or form any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India."

[41] For a perusal of Article 7 (2) of the UN MTC refer Appendix II.

Thailand)[42] reveals that in case of a *building site or construction or assembly projects etc*, the time period of proving the establishment is 183 days, while India's tax treaties with countries like Australia, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland and UK accentuates on six months[43] test while treaties with Norway and Canada for more than three months[44] treaty with USA emphasis on 120 days[45] for being treated as a permanent establishment.

The Indian courts have delivered few important cases on permanent establishment with respect to India-Sri Lanka BTT, India-UK BTT, India-Tanzania BTT and India-Malaysia BTT.[46] The question would be whether only source country would have the exclusive right to tax the income or whether the residence country also has the right to tax such income by granting credit for taxes paid in source country.[47] Under the UN and the OECD MTC, the fundamental principle is that state in which Permanent Establishment is situated may levy tax on such income that could be attributed to it.

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[42] See for example Art. 5(2) (g) of the India-Nepal Tax Treaty, Article 5 (2) (h) of the India-Bangladesh Tax Treaty and India-Sri Lanka Tax Treaty, says that "a building site or construction or assembly project which exists for more than 183 days."

[43] Article 5(2)(j) of the India-UK Tax Treaty defines a building when ought to be considered as a Permanent Establishment's thus,
"2. The term "permanent Establishment" shall include especially:
(j) A building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than six months, or where such project or supervisory activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory activity exceed 10 % of the sale price of the machinery and equipment."

[44] Article 5(2)(h) of the India-Canada Tax Treaty and Article 5(2)(k) of the India-Norway Tax Treaty emphasis on such an establishment to be continuing for more than three months.

[45] Article 5(2)(k) of the India-USA Tax Treaty states that for an establishment to be continuing for a period of more than 120 days in any twelve month period.

[46] *C.I.T* v. *P.V. A. L. Kulandagan Chettiar*, 2004 (267) ITR 654; AIR 2004 SC 3411.

[47] See Sanjay Sanghvi, "Taxability of Profits of Foreign Permanent Establishments of Entities Resident in India-A Controversy", *Bulletin for International Fiscal Documentation*, vol.56, no.11/12, 2002, pp. 390-394.

In the ruling on the interpretation to the India-Sri Lanka Treaty,[48] the assessee was an Indian enterprise having a Permanent Establishment in Sri Lanka. Income earned by that enterprise was repatriated to India and exemption was claimed in India on such income. High Court held that such income should be taxed only in Sri Lanka and not in India emphasizing that Article 7 of the treaty provided for business profits of an enterprise to be taxed only in that state (source state) or else it should carry its business in India through a Permanent Establishment situated therein. The court further held that such income could be taxed only in Sri Lanka and the fact that such income is exempted in Sri Lanka does not give India the right to tax such income.

In the ruling on India-Tanzania Tax Treaty,[49] the court took a deviated view stating that profits of the Permanent Establishment in Tanzania were taxable in India subject to credit being given for taxes paid in Tanzania.[50] Under the India-Malaysia BTT, the court held that a non-resident could not be made subject to taxation in India if they do not have any permanent establishment in India. Therefore Business profits derived out of such rubber estate couldn't be taxed. When a person is a resident of both the Contracting states then the fiscal domicile of the person/assessee shall be determined depending upon the closer relationship (personal and economic relations) that the person has with any of the Contracting States and also his habitual abode.

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[48] See *C.I.T* v. *Lakshmi Textiles Exporters Ltd* (245) ITR 521. The India-Sri Lanka Tax Treaty was concluded on 27-10-1982 and was notified vide GSR 342 (E) dated 19-4-1983.

[49] India-Tanzania Tax Treaty came into existence in 5-9-1979 vide notification GSR 559(E) dated 16-10-1981. See *Bombay Burmah Trading Corporation Ltd.* v. *Assistant C. I. T* (82 ITD 531) (Mumbai Tribunal).

[50] The facts o f the case is that Indian resident entity had earned income from its business activities in Tanzania and claimed exemption from taxation in India under Article 7(2) of the Tax Treaty. In this case the Appellate Tribunal gave an elaborate explanation to Article 7. On Article 7(1), it observed that the profits of an enterprise of a Contracting State shall be taxable only in that Contracting State, when the enterprise carries on business in the other Contracting State through a Permanent Establishment therein situated therefore, such income is taxable only in Tanzania. But the Tribunal while interpreting the entire provision along with the credit method of exemption came to the conclusion that the profits of the permanent establishment in Tanzania can be taxed in India so much so that it would be subject to credit being given for taxes paid in Tanzania.

The rule of force of attraction means that all income of a foreign enterprise operating through a permanent establishment, and the income of such establishment arises anywhere in a country, will be subjected to tax in that country itself.[51] For an income to be taxed under the heads of business profits certain conditions are required to be satisfied like whether the person is actually trading with the country rather than trading with it and also what are the profits. As per the *attribution rule*[52] one has to establish the business presence of the establishment as mandated by Article 5 and 7 of the UN Model.

Further, under the Indian Income Tax Act, we have the provisions, which are highly relevant and directly applicable when computing business profits of a foreign enterprise.[53] Thus, emphasis should be given on the provision that India follows the 'credit' method and not 'exemption' method for the avoidance of double taxation.

3. 3. 4. ii. Associated Enterprises

Most of the BTTs bestow upon the revenue authorities the power to check the nature of the connected enterprises in the Contracting States and to calculate the real profits of the enterprises for the purposes of assessment of tax. Foreign companies or transnational enterprises generally adopt a few methods for tax avoidance. Certain common practices among them are;

1. Shifting of profits to low tax countries by transfer pricing. It is obvious that most of the TNCs engage in transfer pricing, for example they shift their profits to their permanent establishments or associated enterprises, which is situated in a country which has low tax rates, in order to escape

[51] This rule says that a Permanent Establishment attracts to itself all the profits that the enterprise derives from that country – source based principle. Business income is taxed if there is a permanent establishment and non-business income shall also be taxed when such income accrues or arises through or is effectively connected with the establishment.

[52] Attribution rule is known as business connection under Indian Income Tax Act. See also *CIT* v. *Toshoku Ltd.* [1980] 125 ITR 525 (SC) for laying down an interpretation that if no business operations are done, income accruing or arising abroad through or from any business connection in India cannot be deemed to accrue or arise in India.

[53] Section 44D of the Act, deals with computation of royalties of foreign companies. Section 44BBA relates to the computation of profits for the operations of aircraft, 44BBB deals with computation of profits from turnkey power projects, section 44C deals with deductions of office expenses and so on and so forth.

from being taxed in the country where the tax rates are high so that they reap maximum profits.

2. Thin or hidden Capitalisation. It means the practice of excessively funding a branch or subsidiary with interest-bearing loans from related parties rather than with share capital. The intention behind taking such loans is to avoid paying high taxes. This is because interests on such loans are deductible for the borrower and the lender are taxed at a low rate of withholding tax, as he is a non-resident. On the other hand, the company's profits would be taxed wholly on the dividends paid, therefore to avoid paying such high rates of taxes this mode of investment is practiced by the investors.

3. Reducing tax liability by converting income into capital gains. Capital gains are either of low tax rates or are to be taxed according to the laws of the contracting state.[54] If the tax rates of the other contracting state are low then they get more profits.

4. Setting up conduit or intermediary companies outside the home country to process and channellise income from the different foreign sources to secure as much double taxation relief as possible.

5. By virtue of establishing base company in tax havens, the parent companies are benefited in three ways (a) where they can invest in other countries through these countries, (b) they have to pay only nominal taxes, and (c) they can avoid lengthy and time consuming procedures for the establishment of a subsidiary or branch of the company, vis-à-vis maintaining high profits records.

6. These base companies act as a source to hide their unaccounted income because it is a fundamental principle that banks should not leak out their client's capital accounts details. Further, they have to pay very less tax for such investments.

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[54] For example, India-Malaysia Tax Treaty does not define capital gains. The question of defining this term under the treaty came up for consideration in *CIT* v. *PVAL Kulandagan Chettiar's case*, wherein the court held that when the term is not defined in the treaty, it shall be interpreted in the light of the definition given out in the Indian Income Tax Act, 1961.

The most important form of tax avoidance by MNCs is through transfer pricing. For curbing this method of tax avoidance, special provisions were enacted in the Indian Income Tax Act like Section 92 and 93. Tax treaties contain only two ways to solve the problems of international tax avoidance, they are:

(a) Right of revenue authorities to go behind the façade built up by trans nationals and arrive at their real income which is through inclusion of provisions like associated enterprises, and
(b) Arm's length rule.

On transfer pricing issues Income Tax Act has special provision (Section 92[55] of the Act), which was amended *via* Finance Act, 2001 and now it is dealt in Section 92A to 92F of the same. Such amendments were explained in the explanatory Memorandum to the Finance Bill 2001 like this;

> "The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of the country's tax revenues."[56]

It provides that any income, which arises from an international transaction, shall be computed by applying the arm's length price.

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[55]Section 92 of the Indian Income Tax Act, defines transfer pricing thus;
"(1) Any income arising from an international transaction shall be the allowance for any expense or interest arising from an international transaction shall be determined having regard to the arm's length price.
(2) Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cots or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.
(3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into."

[56] Paragraph 176 of the Budget Speech: 2001 (248) ITR 34 Statutes (St.) as cited in Har Govind, "Transfer pricing", *Asia Pacific Tax Bulletin*, vol.9, no.1, 2003, pp.14-21.

3. 3. 4. iii. Capital Gains

Article 13 of the Tax Treaties defines capital gains. This means gains or profits derived by a resident from the alienation of properties. The elements of it is (a) alienation of property, (b) such property can be movable or immovable, (c) It should form part of the business property of the permanent establishment, ships or aircraft, (d) shares of capital stock company of the property which consists principally of immovable property, (e) shares of other companies representing the other companies in the other Contracting States, and any other property. Basically two important elements of capital gains are 'alienation' and 'property.' Alienation connotes the passing of rights in property from one person to another. Under the OECD Commentary it says thus about alienation of property,

> "The Article does not give a detailed definition of the capital gains. This is not necessary for the reasons mentioned above. The words "alienation of property 'are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death'."

The term 'alienation' has to be read in the light of domestic laws of the country, as it is not defined in the tax treaties. For example, India's agreements with Mauritius, Sri Lanka, etc, defines it be sale, exchange, transfer, or relinquishment of the property or the extinguishments of rights therein or compulsory acquisition thereof under any law in force in the respective Contracting States.[57] On a perusal of Indian Income Tax Act[58] and other

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[57] Article 13 (5) of the India-Mauritius Tax Treaty and Article 13(6) of the India - Sri Lanka Tax Treaty defines alienation.

[58] Section 2(47) of the Indian Income Tax Act, defines capital gains. The liability to tax on capital gains arises only if there is a transfer of capital asset. 'Transfer' is inclusive of (i) sale, exchange or relinquishment of a capital asset, (ii) Extinguishments of any rights in a capital asset, (iii) Compulsory acquisition of a capital asset under any law, (iv) conversion of capital asset into stock-in-trade, (v) Handing over possession in part performance of contract of sale and (vi) transfer of rights in immovable properties through the medium of co-operative societies, companies, etc.

domestic laws of India,[59] we find similar reference been made to the definition of transfer. There are three categories of 'property' arises, namely, (i) movable property, (ii) immovable property, and (iii) shares. The term movable property'[60] and immovable property[61] is defined both under the UN and OECD MTC, which emphasizes on the need for the interpretation of this term in the light of definition of immovable property under the domestic laws of the contracting states.

It becomes pertinent in the light of the above-mentioned provisions that we examine the methods of double taxation avoidance adopted by India with different countries and it would be interesting to note why it adopts such different methods.

3. 3. 5. Elimination of Double Taxation under Indian Bilateral Tax Treaties

Indian BTTs follow the 'credit' method and not the 'exemption' method. There are three methods, which have been adopted by the states, namely, (i) Exemption Method, (ii) Credit Method and (iii) Tax Sparing Method. The important distinction between exemption and credit method is that, *firstly,* under the exemption method residence state grants an exclusive right to the source state to levy tax whereas under the credit method it retains its right to tax the total income. *Secondly,* residence state treats the foreign tax under certain limitations as if it were paid to itself. *Thirdly,* exemption method relates to income while credit method relates to tax. Further, under the exemption method, foreign income is excluded from the income of the taxpayer by the residence state but is taken into account for determining the tax rate of other taxable income.[62] The credit method allows credit with respect to the tax paid in the

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[59] Section 53A of the Transfer of Property Act, 1882, defines deemed transfer with respect to part performance of the contract.

[60] It means all property other than immovable property as dealt in Article 13(1) of the UN or OECD MTC. Such movable property includes incorporeal property like goodwill, licences, etc. See D. P. Mittal, *Indian Double Taxation Agreements and Tax Laws*, (New Delhi: Taxmann Allied Service Pvt. Ltd, 2001), at paragraph 19.3.2.

[61] Article 6(2) of the UN MTC. Please refer Appendix II.

[62] See Paragraph 1 of the Article 23A of the UN MTC.

other state.[63] Apart from the exemption and credit method, there is another method called tax sparing method, which means that credit is given not only on tax paid but also in the future tax which would have been payable in the absence of any incentive relief.[64] Tax sparing[65] method is ordinarily a special incentive in order to attract foreign investment in certain areas of industry, or backward areas, which can be termed to be the part of mantra for economic development. The significance lies with the fact that the foreign investor need not pay the tax and in future also, on such an income. 'Tax payable' means that tax which ought to be paid by the taxpayer if there would not have been an exemption for the avoidance. There are certain provisions, which are analogous to tax sparing method of deduction under the Income Tax Act.[66] India-US BTT is one of the examples, which follow tax sparing method for computation of foreign income. It is highlighted that US is the first top foreign investor in India.

3. 3. 6. International Cooperation in BTTs

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[63] In *Nav Bharat Vanijya Ltd.* v. *CIT*, [1980] 123 ITR 865 (cal.) the court held that the credit of tax is given by the residence state in respect the taxes paid on income which in accordance with the provisions of the tax treaty may be taxed in the source state. The words 'in accordance with' would mean an agreement with or harmony with, in conformity to.

[64] When we speak of incentive it is generally the residence state, which is more benefited by such an incentive and not the person who intends to receive it. (though there are some opposing views to it as most of the MNCs or foreign investor invests in a developing country once they believe that they can fetch maximum profit out of that place). For an investor to invest and encourage fee flow of investment it is necessary to let the investor preserve to itself the tax incentive. Thus the relevance of tax treaties, which try to stimulate the investment.

[65]This method has been explained in UNCTAD, *World Investment Report 1998: Trends and Determinants* (New York and Geneva): United Nations Publications, Sales No. E.98.II.D.5, Ch. III, Investment Policy Issues, Bilateral Double Taxation Treaties, paragraph 3, p.80, United Nations Conference on Trade and Development (1999), *International Taxation.* UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations), United Nations Publications, Sales No. E. 99. 11. D; see Fiona Beveridge, *The Treatment and Taxation Of Foreign Investment under International Law* (Oxford: Manchester University Press, 2000) at p. 86.

[66] The provisions are (i) Sections 10, 10A and 10B on tax free income which includes agricultural income etc., (ii) Deductions from gross total income such as development of backward areas, encourage export of goods or merchandise, services, tourism, development of infrastructure as mentioned under Section 80C to 80U, (iii) Income forming part of which no tax is paid (section 86 and 86A).

This section would attempt to study the principle of nondiscrimination because we are trying to analyze the probable issues that may arise in future when taxing the transnational business of the TNCs.. However, under the miscellaneous provisions international cooperation methods like mutual agreement procedure, exchange of information and assistance in collection clause etc., would fall. Further, there would be an emphasis on the principle of non-discrimination One of the major question that arises is as to whether charging of differential tax rate for the non resident companies would amount to discrimination. This brings to the study of nondiscrimination principle and equality principle.

3. 3. 6. i. Nondiscrimination

Article 24 of both OECD and UN MTC and also of most of the BTTs of India deals with this principle. The main objective of this principle is that no nationals of any other contracting state shall be subjected to any taxation requirements more burdensome than that which nationals of the other state in the same circumstances are required to. Apart from this, supplementary objectives are to prevent discrimination of nationals, stateless persons, residents and enterprises of the treaty partners.[67] This is based on the equality principle. This principle is of three kinds; (i) *Nationality non-discrimination,*[68] (ii) *Permanent establishment non-discrimination*[69] (iii) *Ownership nondiscrimination.*[70]

[67] Paragraph 1 to Article 24 deals with 'any taxation or any requirement connected therewith of treaty partner nationals', paragraph 3 deals with stateless person, paragraph 4 deals with resident and paragraph 6 elaborates on the taxation of an enterprise of a treaty partner resident.

[68] Paragraph 1, 2 and 3 to Article 24 says that no nationals shall be discriminated on any basis. Paragraph 1 to the UN and OECD MTC prohibits any kind of discrimination on the basis of nationality.

[69] Paragraph 4 and 5 to Article 24 says that this provision one state is obliged to not to discriminate between its own enterprise and permanent establishment of a foreign enterprise carrying out the 'same activities' in the matter relating to taxation so that 'taxation is not less favourably levied.'

[70] Article 24(6) says that one should not discriminate an enterprise on the basis of its capital being owned wholly or partially, directly or indirectly, by residents of the other contracting states.

An important aspect of the Tax Treaties is with respect to *amendment* provision that is supplemented by enacting one or more protocols to the tax treaties.[71] Any amendment to the Agreement made by way of a Protocol, would legally come into effect by modifying the Agreement. So far India has amended its three Agreements by enacting a Protocol.[72] Apart from bilaterally avoiding double taxation, Indian Income Tax has unilateral methods to prevent it, which is briefly dealt in the subsequent section.

3. 4. Unilateral relief to Eliminate Double Taxation under the Indian Tax law

The question of unilateral relief of avoiding double taxation for the residents of India arises only when there is no BTT with the other contracting state. This relief is granted under Section 91 of the Indian Income Tax Act. As per the provision such relief is granted on the same income in cases where such income accrues or arises in a country with which India has not entered into an agreement for avoidance of double taxation. Further, the resident taxpayer has to prove that he has paid income tax in any other country by way of deduction of tax at source or otherwise under the law in force in that country on the same income which is subjected to tax in India for the same assessment year.[73] In the light of the above-mentioned submissions, it would be pertinent to know the position or status of the BTTs in the Indian domestic law.

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[71] See Mukesh Butani, "Tax Treaty Interpretation", *Asia Pacific Tax Bulletin*, vol.10, no.1/2, (2004), pp.56-69 at p.66.

[72] The three Agreements are with Finland, New Zealand and Switzerland. As per the India-Finland Tax Treaty it was concluded on 10th June 1983 and notified vide GSR 786 (E) dated 20-11-1984. The Protocol became effective on 1st April 1999. The India-New Zealand Tax Treaty was concluded on 17th October 1986 and notified vide GSR 756 (E) dated 9th September 1987. Two Protocols were enacted on income and became effective on 1st February 1997 and 1st April 2000. The India-Switzerland Tax Treaty was concluded on 2nd November 1994, its Protocol came into effect on 1st April 2001.

[73] See Sub-section 1 to Section 90 of the Indian Income Tax Act, 1961. See *CIT* v. *Carew and Co. Ltd.* (1979) 120 ITR 540 (SC); wherein it laid down that if a resident derives income from foreign business in India and in a foreign country and agricultural income in a foreign country (agricultural income is not taxable in India) he is liable to pay tax on the whole income in India. Such assessee would be entitled to double taxation relief if he has incurred any loss from such agriculture. According to Sub-section 3, relief is granted to a non-resident, on the shares of a resident registered firm in India, if the assessee is a partner to such firm during the assessment year and he has already paid income tax in that other country.

3. 5. Overriding effect of the Tax Treaties over the Indian Income Tax Act, 1961.

The Indian Income Tax Act should give way to Tax Treaties whenever there is an interpretation given to it. There are some cases, which emphasis that whenever there is a conflict between the provisions of the Indian Income Tax Act, 1961, and the provisions of the BTTs, the treaty provision shall prevail over the general Act[74]. In fact, the tax treaties itself lay down that the laws in force in either countries will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the tax treaty.[75] While interpreting the India-Singapore Tax Treaty, the Authority for Advance Ruling observed that the specific provisions of the Agreement would override the general provisions of the Indian Income Tax Act and therefore, it is essential for everyone to be guided by the specific articles, terms, conditions and rules contained in the Agreement between India and the respective other contracting state.[76] A tax treaty is intended to relieve liability and hence can never impose liability.

3. 6. Conclusion

A perusal of the BTTs signed by India shows that the number of tax treaties signed after the liberalisation policy is substantially high. This raises a

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[74] See *CIT* v. *Visakhapatnam Port Trust,* (1983) 144 ITR 146 (AP); *CIT* v. *Davy Ashmore India Ltd.,* (1991) 190 ITR 626 (Cal); *CIT* v. *R. M. Muthaih,* (1993) 202 ITR 508 (Kar); *CIT* v. *VR.S.R.M Firm and others,* (1994) 208 ITR 400 (Mad.); *Arabian Express Line Ltd of UK* v. *Union of India* (1995) 212 ITR 31 (Guj); *CIT* v. *Estienne Andre and others,* (2000) 242 ITR 422 (Bom).

[75] Vide circular No. 333 of 2nd April 1982, issued by the Central Board of Direct Taxes. Paragraph 2 to the same reads thus; "The correct legal position is that where a specific provision is made in the double taxation avoidance agreement, the provision will prevail over the general provisions contained in the Income-Tax Act. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government under Section 90 of the Income-Tax Act, also provide that the laws in force in either country will continue to govern the assessment and taxation of income In the respective countries except where provisions to the contrary have been made in the Agreement."

[76] See Advance Ruling in A. No. P11 of 1995 In Re (1997) 228 ITR 55 as cited in R. Santhanam, "Handbook on Double Taxation Avoidance Agreement Tax Planning For Collaborations", (New Delhi: Commercial Law Publishers (India) Pvt. Ltd, 2004) at p. 564.

query as to why there has been such a radical change. In an affirmative manner the Indian government argued that apart from promoting foreign investment, the main motive was to give relief to Indian taxes so that in the long run India would be in an advantageous position in terms of FDI flow. Thus, we encouraged foreign investment after the NIP, 1991 and it lead to major investments in India from countries like Mauritius, United Kingdom, and certain other developing countries. Both BIPAs and BTTs have played a key role in generating the FDI in India.

Indian Judiciary plays a significant role in giving sanctity to this BTTs. Through various judgments delivered, it has emphasized that *the treaty provisions override the domestic law (Indian Income Tax Act, 1961).* As far as India is concerned, it adopts an international agreement by giving ratification to it and enacting subsequent legislation in India based on that agreement. The Indian courts have dealt with international agreements and have given them only a supplementary stand to the Indian domestic law, that is, they supplement the Indian laws while delivering a judgment by the Indian courts based on Indian laws. Deviating from this practice, with respect to BTTs, the courts have always decided that the treaty provisions are to be given more importance and that whenever there is a dispute based on the treaty provision, Indian Income Tax Act should supplement them. Therefore, this is perhaps the only area of law in India, where an international agreement prevails ove- domestic law in domestic court. This is because of the dual nature of the tax treaties as they are considered both as an international agreement and a mini legislation as well in India.

Chapter IV

Implementing Indian Tax Treaties: Case Studies

CHAPTER IV

IMPLEMENTING INDIAN TAX TREATIES: CASE STUDIES

4. 1. Introduction

The Indian domestic tax law enables the government to enter into tax treaties as per Section 90(1) of the Indian Income Tax Act, 1961. In 1991, by way of India's liberalization policies Indian economy was opened up for international trade. India opened up her economy when there was a severe balance of payment crisis.[1] With the liberalization of exchange control regulations in India, the Foreign Institutional Investors (FIIs) were permitted to make portfolio investments in the Indian stock market.[2]

In this chapter, four BTTs would be analysed since they are the top foreign investors in India. These treaties are:

1. *India-Mauritius Tax Treaty*, because Mauritius apart from being the second largest foreign investor of the country is also a proposed tax haven country.
2. *India-Malaysia Tax Treaty*, because it is a developing country as well as member of ASEAN.
3. *India-United States Tax Treaty*, for United States is a developed country and the major foreign investor in India
4. *India-United Kingdom Tax Treaty*, as United Kingdom is one of the developed countries whose domestic law has influenced the Indian laws.

In the following section we shall examine each treaty, based on its significance to the Indian economy, and its main features. The focus of this chapter would be to study the interpretational nuances of these tax treaties and its implication to India.

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[1] Lack of infrastructure, scarcity of domestic resources and inefficiency of public sector had compelled the government to open their economy.

[2] For details see Chapter III sections 3.1 and 3.2.

4. 2. India-Mauritius Tax Treaty, 1983

This treaty was entered into on 24th August 1982[3] and came legally into effect only in 1991.[4] The purpose of such a tax treaty is to 'avoid double taxation and prevent fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment'[5]. This treaty is distinctive and a controversial one.[6] It gave the taxing rights on capital gains to Mauritius under Article 13 of the Treaty,[7] because Mauritius acted as a tax shelter in respect of capital gains on divestment of equity shares in Indian companies by Mauritius offshore business entities.

4. 2. 1. Scope and applicability of the Treaty

The provisions of the treaty shall apply only to 'residents'[8] of both the Contracting States. The taxes that are covered under the treaty are Indian income tax and Mauritius income tax.[9]

4. 2. 2. A brief description of the controversy

The controversy arose when the Central Board of Direct Taxes (hereafter referred to as CBDT) issued a Circular No.789, which clarified, that

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[3] The treaty is entered between Government of India and Government of Mauritius on April 1, 1983. This treaty formally came into force through a Notification No. GSR 920 (E) dated December 6, 1983. For the text of India's all BTTs, see Taxes and Investments in Asia and the Pacific, Treaties C, (Amsterdam, IBFD, 2004); see also www.finmin.nic.in.

[4] In 1991, when Indian economy was opened up as a part of liberalization policies, FDI was looked upon as the ingredient for improving the economy. On this basis Mauritian companies including the FIIs and Offshore companies started investing in India .

[5] See Preamble to the India – Mauritius Tax Treaty, 1982.

[6] See an Article in the daily, "Flaws in Tax Treaties Caused Havoc in Bourses: CAG," The Hindu , (New Delhi), 10th May 2005 at p. 13.

[7] See Mukesh Butani, "Tax Treaty Interpretation", *Asia Pacific Tax Bulletin*, vol.10, no.1/2, pp.56-69, at p. 56.

[8] A resident has been defined in Article 4 of the treaty. For being a resident one has to prove his domicile, residence when it is an individual, and place of management when it is any company or any other entity, corporate or non-corporate.

[9] See Article 2 of the Tax Treaty.

whenever a residency certificate is issued by Mauritius authorities it would be sufficient to prove the residential status of the companies. Relying on which they are exempted from taxation in India on the presumption that they will be taxed in Mauritius. The dispute arose when income tax authorities taxed these companies or FIIs and they claimed exemption on the basis of the circular. Agitated by this, Public Interest Litigation was filed before the Delhi High Court.

In order to know the controversy in detail it is essential to study the background for FIIs investment in India and why they were exempted from taxation in India and had to pay a very nominal tax in Mauritius. In the course of study we shall deal with the Mauritius domestic laws which have a liberal attitude giving relaxation to these companies.

4. 2. 3. Mauritius: A Proposed Tax Haven

Mauritius is considered to be a global business center.[10] It has liberal tax policies, and has various tax rates for different entities and due to this Mauritius has become a channel for investment in India. From Mauritius alone India receives Rs.20, 585 crores, as FDI which is approximately 20% of the total inflows.[11] The reasons for considering Mauritius as a global business center or a channel of investment are many, the prime being;

(i) Its DTAAs or BTTs entered between various countries[12] and

(ii) Its special domestic legislation -Mauritius Offshore Business Activities Act (MOBA), 1992.'

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[10] See generally, Noshir M. Lam, (et al.), n. 14 at p. 100.

[11] USA is the second largest source of FDI in India since 1991. This has lead to economic development as employment, business; standard of living etc. has increased.

[12] Till 2002, it had ratified 26 tax treaties and several other treaties are under consideration. The tax treaties ratified by Mauritius are with (1) Belgium, (2) Botswana, (3) Cyprus, (4) France, (5) Germany, (6) India, (7) Indonesia, (8) Italy, (9) Kuwait, (10) Luxembourg, (11) Madagascar, (12) Malaysia, (13) Mozambique, (14) Namibia, (15) Nepal, (16) Oman, (17) Pakistan, (18) China, (19) Singapore, (20) South Africa, (21) Sri Lanka, (22) Swaziland, (23) Sweden, (24) Thailand, (25) United Kingdom and (26) Zimbabwe.

This legislation is important because it established MOBA Authority, which is the regulating authority for the offshore business activities within Mauritius and issues certificate of residence to such enterprises. These offshore companies were in fact having only paper existence in Mauritius[13] and such relaxations in the legislation lead to major investments in India through Mauritius. In Mauritius, a resident company[14] is liable to taxation on its worldwide income and, for the taxation of foreign branches, the tax is computed in the same way as it computes its resident company. The benefits of the India-Mauritius Tax treaty are given only to residents; and a foreign company may claim the benefits of the tax treaty by obtaining a 'Tax Residency Certificate'[15] from the Competent authority of Mauritius.

The increased FDI flow and investment by the FIIs in India created a havoc among the Indian companies since many foreign investors in India were

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[13]According to the Preamble of the MOBA, it was enacted 'to provide for the establishment and management of the MOBA authority to regulate offshore business activities from within Mauritius for the issue of offshore certificates, and to provide for other ancillary or incidental matters'.

Section 26 of the MOBA, reads as follows, "An offshore company shall not hold any immovable property in Mauritius and shall not hold any share or any interest in any company incorporated under the Companies Act, 1984, other than in a foreign company or in another offshore company or in an offshore trust or an international company. An offshore company shall not hold any account in a domestic bank in Mauritian rupees, except for the purpose of its day to day transactions arising from its ordinary operations in Mauritius."[13]As quoted in [2003], 263 ITR 706, at p. 740.

[14] A resident company as per Section 73(b) of their income tax act, means 'a company which is incorporated in Mauritius or has its central management and control in Mauritius'.

[15] See Noshir M. Lam, Mayur Nayak, and Mittil Chokshi, *Mauritus: International Business and Tax Strategies*, edn. 1 (Snow White, 2002) at p. 101, for the conditions to get a Tax Residency Certificate when the companies satisfy these conditions;

1. The company must have at least two resident directors of appropriate caliber to exercise independence of mind and judgment.
2. The company secretary must be resident in Mauritius.
3. The registered office must be in Mauritius.
4. Banking transactions must be channeled through an offshore bank account in Mauritius,
5. Board Meetings must be held in or chaired from Mauritius.
6. Accounting records must be maintained in Mauritius in accordance with the Companies Act, 1984.
7. All statutory records, such as minutes and members register, must be kept at the registered office.
8. Auditors, must be Mauritius resident.
9. For Investment Funds, there must be a local custodian of Mauritian assets and the Net Asset Value must be calculated in Mauritius.

making use of Mauritius as a business route and claimed exemption in India arguing that they were residents of Mauritius and had paid tax there. Further, the existence of provisions on 'capital gains' and 'dividends' (Article 13[16] and 10[17] of the India – Mauritius Tax Treaty) bestowed Mauritius with the taxing rights.[18] Under Article 10 of the treaty, dividends received by a Mauritius resident as a beneficial owner are taxed at a concessional rate of 5% or 15% in India, this concession is given depending upon the extent of shares held by the Mauritius resident in the Indian company which pays such dividend. Relying on

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[16] Article 13 of the India – Mauritius Tax Treaty defines 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 extinguishments of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States".
Further, Paragraph 4 of the Circular No. 682 issued on 30 March 1994 deals with this principle.

[17] Article 10 (1) and (2) of the India- Mauritius Tax Treaty: 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) 5% 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) 15% 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."

[18] Further, reaffirmed by *Circular 682(3)* issued by the CBDT issued on 30 March 1994 reads thus;

"3. Paragraph 4 deals with taxation of capital gains arising from the alienation of property other than those mentioned in the preceding paragraphs and gives the right to taxation of capital gains only to that state of which the person deriving the capital gains is a resident. *In terms of paragraph 4, capital gains derived by a resident of Mauritius by alienation of shares of the companies can be taxable only in Mauritius according to Mauritius tax law.* Therefore, any resident of Mauritius deriving income from alienation of shares of Indian companies will be liable to capital gains tax only in Mauritius as per Mauritius tax law and will not have any capital tax liability in India."

this, various FIIs invested large amounts in capital shares in Indian companies expecting to make profits by selling such shares without being taxed in India. The presence of such a liberal provision in the tax treaty lead to the large number of foreign investment in India making Mauritius as a base.

As a result, in 2000, Indian Revenue Authorities[19] found that there was large number of 'shell companies,'[20] which had a permanent establishment in Mauritius yet they were in reality conducting their business from certain other countries. Therefore, the authority issued show-cause notices[21] to these companies, which lead to the withdrawal of investment from Indian capital market by FIIs. Fearing a great financial loss that would occur once the Mauritius companies withdrew their FDI's, the Central Board of Direct Taxes (CBDT) issued a Circular 789[22] on 13th April 2000, which clarified that wherever a certificate of residence was issued, by the Mauritius authorities, it would be valid enough to prove the residential status of these companies and they need not pay tax in India.

The circular became a real controversy, as there was discrimination between Indian companies and the foreign investor investing through Mauritius. Further, the companies, which originally did not belong to Mauritius, were

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[19] The 'Competent authority' within the meaning of Article 2 (h) of the India – Mauritius Tax Treaty which defines the term as "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;"

[20] Shell companies are those companies, which have only paper existence in Mauritius, and they do their business investments in India.

[21] The revenue authorities issued show-cause notice claming them to pay tax as why they should not be denied the benefits of tax treaty. These FIIs were actually controlled and managed by other countries and were not actual residents of Mauritius. As they were not eligible to claim the tax treaty benefit, assessment orders were passed accordingly.

[22] The relevant provision of the Circular 789 (3) is;
"Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. *It is hereby clarified that wherever a certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.*"[22] (Emphasis in original).
Paragraph 3 of the Circular 789 issued by the CBDT on 13th April 2000. The circular was challenged for its validity through Public Interest Litigation before Delhi High Court in *Shiva Kant Jha* v. *Union of India* [2002] (256) ITR 563.

claiming the Tax Treaty benefits. This lead to two Public Interest Litigation before the Delhi High Court challenging the validity of Circular 789 of 2000 issued by the Central Board of Direct Taxes.

4. 2. 4. Indian Judiciary's stand on India-Mauritius Tax Treaty

The Delhi High court delivered its judgment[23] declaring the impugned Circular to be quashed, *inter alia*, on two major grounds. Firstly, that the Circular cannot interfere with the rights of the Assessing officer to call for and examine evidence to verify the genuineness of a taxpayer's claim; and secondly, the subject income liable to be taxed should be taxed in both the countries. This ruling was supposed to bring to an end the 'treaty shopping'[24] business by investors through Mauritius.

This case is important for it interpreted Article 13 of the Treaty and is an evidence of the increased FDI in India after the liberalisation of economic policy.[25] The Delhi High Court held that the impugned circular is invalid and should be quashed.[26]

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[23] See *Shiva Kant Jha* v. *Union of India*, [2002] 256 ITR 563. The facts therein stated Mauritius to be a tax haven, as a result treaty shoppers from Luxembourg and other western countries used Mauritius as a business route for investment, and these companies were set up in Mauritius through which they made investments in order to avoid incidence of taxation.

[24] This concept enables a person claiming to be resident (while it is only in papers) in country from which treaty protection or exemption is sought.

[25] See *Shiva Kant Jha's case* at p. 567. Relying on facts it states "Having regard to the globalization of economic policy adopted by India, relaxation on regulations and controls on direct foreign investment took place in 1992 wherefore guidelines have been announced. The said Convention, as would appear from its Preamble, *was entered into for the encouragement of mutual trade and investment in India and Mauritius.*"

[26] The court came to the judgment that;

- The circular does not show that it has been issued under section 119 of the Indian Income Tax Act, 1961, and therefore it would not be legally binding on the revenue;
- The CBDT has no authority to issue directions to income tax authorities to accept any certificate of residence issued by Mauritius authorities, as it is ultra vires;
- The residential certificate issued by the authorities cannot be regarded as conclusive, as it is not contemplated under the treaty or under the Act;

The income tax officers have the authority to lift the corporate veil in order to find out whether the purpose of finding out whether the purpose of the corporate veil is avoidance of tax or not.

In the light of such a decision the respondents - Union of India and Global Business Institute (a Mauritius based non-profit organization), filed a Special Leave Petition challenging the Delhi High Court's decision. The Honourable Supreme Court[27] on appeal declared the impugned circular to be valid and reversed the Delhi High Court's decision.

This judgment is noteworthy as it laid down some fundamental aspects of interpretation of tax treaties.[28] The Honourable Court held that the charging sections like Section 4 and 5 of the Indian Income Tax Act, is made subject to Section 90 of the same. The court has dealt with these issues in detail by attempting to answer the following issues;

- Whether the impugned Circular is ultra vires Section 119 of the Act?
- Is the India-Mauritius Tax Treaty bad for excessive delegation?
- Is the India-Mauritius Tax Treaty illegal and ultra vires the powers of the Central Government under Section 90?
- What is "liable to taxation"?
- Is treaty shopping[29] illegal?
- What interpretation should be given to these tax treaties?

In summary, the Court held that the powers bestowed on the Central Board of Direct Taxes to issue circulars as per Section 119 is valid and it does not in any way 'crib, cabin or confine' the powers of the Indian tax officers with

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[27] *Union of India* v *Azadi Bachao Andolan*, [2003] 263 ITR 706. The decision was rendered on October 7, 2003.

[28]A MTC or a BTT has a dual nature, (i) as an international agreement entered between two states and (ii) as a domestic tax law as and when they are agreed upon. In this section, there would be an emphasis on the nature of a tax treaty as an international treaty, thereby invoking the provisions of Vienna Convention on the Law of Treaties, 1969. Article 31 to 33 of the Vienna Convention on the Law of Treaties, deals with the interpretation of treaties. Article 31 paragraph 1 of the Vienna Convention on Law of The Treaties, requires a treaty to be interpreted in 'good faith.' According to Sinclair;

> "... good faith applies to the entire process of interpretation, including the examination of the text, the context and subsequent practice. In addition, the result obtained must be appreciated in good faith – that is to say good faith as an objective criterion in the light of the particular circumstances, not good faith as an abstract notion."

It is a well-settled law that a bilateral treaty is concluded only through thorough negotiations by each Contracting States and therefore, they are to be followed in good faith.

[29]One of the essential features of *treaty shopping* is the establishment of base companies in other states only for the purpose of enjoying the tax benefits of a particular treaty rules existing between the state and the third state.

any particular assessment made, provided they lay down broad guidelines which has to be followed by the income tax officers in the matter of assessment of taxpayers covered by the provisions of the tax treaty. It added more significance to the powers of the CBDT when it declared that they are legally binding upon the subordinate authorities.[30] *Therefore, whenever there is inconsistency with the income tax law, the treaty law and any circular issued under the treaty shall prevail over the income tax.*

The tax treaty entered into between Government of India and Government of Mauritius is not a bad legislation as it was enacted within the parameters of legislative provision from which it derives its powers.[31] Moreover, the purpose of the tax treaty is to effectuate the prescribed objectives that is, to grant relief in respect of which income tax has been paid in India and a foreign country and avoidance of double taxation of income under the Act and under the foreign country's tax laws.

The test of 'liability to tax'[32] is determined by taking into account the entire legislations that exist in both the Contracting States on tax laws. For example, a resident is taxed based on the legal liability to tax in a particular

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[30]The court relied on the following decisions of the Supreme Court of India, while determining the legal status of the circulars issued by the CBDT. See *K. P. Varghese* v. *ITO* [1981] 131 ITR 597 (SC); *UCO Bank* v. *CIT* [1999] 237 ITR 889, 896, regarding the legal status of the circulars;

> "The Board has thus the power, *inter alia*, to tone down the rigour of the law and ensure a fair enforcement of its provisions, by issuing circulars in exercise of its statutory powers under section 119 of the Income Tax Act which are binding on the authorities in the administration of the Act. ...The power is given for the purpose of just, proper and efficient management of the work of assessment and in public interest. It is a beneficial power given to the Board for the proper administration of fiscal law so that undue hardship may not be caused to the assessee and the fiscal laws may be correctly applied."

[31] Section 90 of the Indian Income Tax Act, 1961.

[32] Phillip Baker, *Double taxation Conventions: A Manual on the OECD Model Tax Convention on Income and Capital* (London: Sweet and Maxwell, 2001), p.B-11. Relying on Philip Baker's argument on first sentence in the OECD Convention,

> "It seems clear that a person does not have to be actually paying tax to be 'liable to tax' – otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the convention. It also seems clear that a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, if the exemption were repealed, or the person no longer qualified for the exemption, the person would be liable to comprehensive taxation."

country and not according to the fiscal fact of actual payment of tax. Court stated that liability to tax is a legal situation whereas payment of tax is a fiscal act, in order to apply Article 4 of the treaty, the situation ought to be legal one.

Thus, if the Mauritius government had granted some exemption from taxation some source of income, like capital gains, it does not imply that the taxpayer is not 'liable to tax'. In the light of these contentions it becomes evident that the foreign financial institutional investors are exempted from taxation on certain incomes like the capital gains but it could not be a reasonable ground to justify that they do not pay tax at all, as they are residents in Mauritius.

The court reaffirmed that treaty rules prevail over domestic law. [33]

4. 2. 4. i. Legality of Treaty Shopping

Another significance of this decision is that it dealt with 'treaty shopping'. This term cannot be classified as illegal just because residents of third country are benefited by the India-Mauritius tax Treaty. According to Lord McNair, if there is no express provision excluding the nationals of third states from claiming the benefit of the law, then that law can be applied to them also.[34] As there is no provision in the India-Mauritius Tax Treaty, which expressly mentions that, it would not be applicable to residents of 'third state', it cannot be interpreted on the contrary. If the legislative intent was to incorporate such 'a suitable term of limitation'[35] then it could have incorporated it in the Tax

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[33] The Circular No. 333 issued by the Central Board of Direct Taxes (CBDT) is noteworthy as it specifies that where a special provision is made in a tax treaty it would prevail over the general law (generalia specialibis non-derogant - This Latin maxim '*generalia specialibis non-derogant*' means special law shall prevail over general law.). There are few judicial decisions of Honourable Supreme Court of India, which declares this fundamental principle on avoidance of double taxation. CIT v. R. M. Muthiah 202 ITR 508 (Kar); CIT v. Hindustan Paper Corporation Ltd. 77 Taxmann 450 (Cal); *Union of India* v. *Azadi Bachao Andolan*, [2003] 263 ITR 706 (SC).

[34]According to Lord McNair, "that any necessary implementation by municipal law has been carried out, there is nothing to prevent the nationals of 'third states', in the absence of any express or implied provision to the contrary, from claiming the rights, or becoming subject to the obligations, created." See McNair, *The Law of Treaties* (Oxford: the Clarendon Press), 1961, at p. 336.

[35] See, n. 26, at p. 747.

Treaty. Upholding the legality of the treaty-shopping clause, the court held that as these treaties acts as an instrument of economic development, a developing country like India should not be restricting its views. Further, many developing countries have already accepted this principle, so as to attract scarce foreign capital and technology.

On the interpretation of treaties, the principles adopted in the interpretation of treaties are not the same as those adopted in the interpretation of the statutory legislation; and that since these treaties are negotiated and entered into agreement at the political level, it has several considerations as their bases[36].

4. 2. 5. Other Judicial Decisions under India – Mauritius Tax Treaty

Other very crucial decisions relating to the India-Mauritius tax Treaty are *Natwest Case*,[37] *AIG's Case*,[38] and *DLJMB Mauritius Investment Co.* v. *CIT*.[39] For a better understanding of the tax treaty, we need to examine the

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[36] See David R. Davis, *Principles of International Double Taxation Relief*, (London: Sweet and Maxwell), 1985, at. p. 4. Wherein he points out that the main function of the double taxation 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; See *Azadai Bacaho Andolan case* at p. 751.

[37] Advance Ruling No. P. 9 of 1995-220 ITR 377.

[38] Advance Ruling P. No. 10 of 1996-224 ITR 473. The facts of the case is that the applicants were two companies, one was an investor company (an American company) and the other was investment manager, incorporated in Mauritius. This company had active participation in Asian economies and with the investors world over and proposed to set up a fund in collaboration with an Indian financial services company. The Authority for Advance Ruling (hereinafter referred to as AAR) ruled that the tax concession under the Indo-Mauritius Tax Treaty was one of the factors taken into account and Indian laws imposed various restrictions like exchange control regulations and time consuming Foreign Investment Promotion Board (hereinafter referred to as FIPA) approvals for purchase or sale of investments by foreign investors. Therefore, channeling investments in India through the Mauritius entity was considered appropriate.

[39] Advance Ruling No. 315 of 1997, (1997) 228 ITR 268 (AAR); In this case the applicant company was incorporated as a limited liability company in Mauritius as an offshore ordinary company and regulated by the MOBA. It was a subsidiary of DLJ Company, which was a leading investment and Merchant Bank in USA, and it obtained a tax residency certificate. The Authority gave a decision that was based on these grounds; (i) the applicant company gave explanations as to why it should channellise funds through one such entity, and that investing in

rulings of these case laws. In the *Natwest Case*[40] the authority had made the contention that the London based Natwest bank was using Mauritius as a route to invest in India in order to avoid tax. In this ruling the AAR held that it is proved beyond reasonable doubt that the Natwest Bank intended to conduct its business in India not through its Mauritius subsidiary but directly. In the case, the AAR inferred that the shares as well as the income arising out of the HDFC Bank were held by the Mauritius subsidiaries of the applicant bank only under the control and direction of the sole shareholder, which is the applicant bank.

4. 2. 6. Interpretational Nuances in the Tax Treaty: An Analysis

The main problem was whether to tax the FIIs who were residents of Mauritius. The income earned and liable to tax was based on capital gains and dividends, which were exempted. The whole issue came up because these FIIs were residents of Mauritius. According to the facts it is suggested that we could amend the provisions like resident, permanent establishment and capital gains in order to make our law strict and thereby generate revenue. If one may examine the term resident under the Tax Treaty, residential status of a person other than individual means the place where effective management takes place. It does not emphasize what should be the criteria to determine the place of effective management. It is suggested that by virtue of a circular issued by the CBDT it could be decided that all the approaches namely, facts and circumstances approach, thumb rule along with the 'head and brain' approach (as mandated in the Indian Income Tax Act, meaning, i.e., affairs of policy, finance, disposal of profits and vital things concerning company's management, place of Meetings of the Board of Directors, etc.), could be applied. It would mean that these FIIs

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India is a cumbersome procedure. Also, Mauritius has become a well-developed and cost effective offshore financial center (ii) The company's effective management and control was in Mauritius as it has obtained tax residency certificate from the Mauritian authority, which means the applicant company, is a resident of Mauritius.

[40] In this case the applicants were two limited liability companies incorporated in Mauritius and subsidiaries of a British Bank. These companies were in all legal terms residents of Mauritius. The applicant company had invested in an Indian Bank (HDFC Bank) for an amount of US $ 6 million each. The most important issue raised before the authority were as to whether capital gains on transfer of equity shares in the Indian bank was exempt from Indian Income tax under Article 13 of the treaty

which were claimed to be shell companies and whose head offices are situated elsewhere shall be made liable to be taxed in India as foreign companies, and we could avoid Mauritius as a route of investment. Further, *a relaxation in the procedures* and strict regulation in compliance with the domestic laws of India (and international standard like human rights obligations, environmental standards, consumer's protection in terms of interest, health and standard, etc) in establishment of foreign companies in India, would be a method to attract foreign investment as mandated by the Indian Government.

4. 3. India – Malaysia Tax Treaty[41]

Malaysia is also one of the top foreign investors of India. A new treaty has been concluded but has not yet come into force. This treaty also says that it is applicable to the residents of both contracting states and it shall be determined in accordance with his fiscal domicile.[42] This treaty stands significant for Malaysia is one of the ASEAN countries also. On a comparative analysis of the tax treaties of other ASEAN countries, there are some differences among them.

This treaty has been subject to interpretations, which were remedied through various judicial decisions[43] of the Indian courts. The concepts, which have frequently been under consideration, were on immovable property, business profits, shipping, associated enterprises, dividends and elimination of double taxation.

[41] This treaty was signed on 25th October 1976 and notified vide GSR 167 (E) dated 1st April 1977 and a new treaty was signed on 14th May 2001; For the text of treaties, see n. 3.

[42] See Article 4 of the India-Malaysia Tax Treaty, which defines fiscal domicile. Also, *CIT* v. *P. V. A. L. Kulandagan Chettiar*, 2004 (267) ITR 654; AIR 2004 SC 3411, for a detailed interpretation.

[43] The judicial decisions are *P. V. A. L. Kulandagan Chettiar* v. *Income Tax Officer* (ITO) (1983) 3 ITD 426; *CIT* v. *R. N. Muthaih* (1993) 202 ITR 508; *CIT* v. *Kalyanakrishanan* (1992) 195 ITR 534 (Mad); *CIT* v. *V. R. S. R. M. Firm* (1994) 208 ITR 400 (Mad); *CIT* v. *Muthukaruppan* (1998) 230 562 (Mad); *CIT* v. *Unnamalal Achi* (2001) 251 ITR 860 (Mad); *CIT* v. *O. R. M. S. S. S Sevugan Chettiar* (2000) 241 ITR 662; *Ayer Mani's Rubber estate Ltd.* v. *IAC* (1993) 46 ITD 429 (Mad); *CIT* v. *Turuuoise Investments & Finance Ltd.* (2004) 89 155 (Indore); *CIT* v. *Ballarpur Industries Ltd.* (2003) 80 TTJ (Nagpur) 975; *Takniskil (Sendirian) Berhard* v. *CIT* (1996) 135 CTR 292 (AAR); *CIT* v. *Mrs. Shamsunissa* (1999) 239 ITR 602 (Mad).

One of the important features of the treaty is that it does not define 'capital gains', but it came up for consideration in *Commissioner of Income Tax v. P. V. A. L. Kulandagan Chettiar.*[44] One of the arguments raised was that capital gains is not an income, therefore, it would not be covered under the treaty. Court held that;

> "...because in the terms of the treaty wherever any expression is not defined the expression defined in the Income Tax Act, would be attracted. Thus, capital gains derived from immovable property is income and therefore Article 6 would be attracted."[45]

One of the distinctions of this treaty from India-Mauritius Tax Treaty is that the term 'immovable property' includes the words "timber and forest produce"[46] also. The term 'business income'[47] (derived from a rubber estate) under the India-Malaysia DTAA came up for consideration. This decision stands relevant as it dealt with two important aspects namely; fiscal domicile and capital gains. The court held that

- The non-resident could not be made subject to taxation in India if they do not have any permanent establishment in India. Therefore Business profits derived out of such rubber estate couldn't be taxed.
- When a person is a resident of both the Contracting States then the fiscal domicile of the person/assessee shall be determined depending upon the closer relationship (personal and economic relations) that the person has with any of the Contracting States and also his habitual abode.[48]

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[44] 2004 (267) ITR 654; AIR 2004 SC 3411. The facts of the case in brief - the respondent is a firm having immovable property in Malaysia. It earned some income out of it, and also it had sold a property, which Indian competent authority (Income tax Officer) charged them and were held liable to pay the tax.

[45] Ibid, paragraph 19, at p. 3422.

[46] The last sentence of paragraph 2 of Article 6; the words "timber and forest produce"

[47] The business income is classified into exports and business profits, personal services which include dependent and independent services, director's fee, pensions, government services, students, shipping, inland waterways transport and air transport and purchases.

[48] See n. 44, at p. 3421.

- Further, capital gains are income derived from immovable property; therefore it would attract Article 6[49] of the treaty, and sale of immovable property would lead to taxation under the heads of income – "capital gains". On the other hand, if the capital gains arise out of the alienation of immovable property situated outside India, it is not liable to be taxed.
- Income derived from skilled labour, it would result in fees and technical services,[50] and thereby it forms part of 'business income.'[51]
- The income alleged to accrue or deemed to accrue or arise in India out of business profits is not subject to taxation in India under Section 9 of the Indian Income Tax Act.

Generally the term capital gains is inclusive of gains from alienation of (i) immovable property, (ii) movable property, (iii) ships and aircraft operating in international traffic and (iv) any other property (inclusive of share too). Since the provision is excluded from the treaty and applying the interpretation given

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[49]Income from Immovable property is defined under Article 6 as:
"1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.
2. The term "immovable property" shall be defined in accordance with the laws of the Contracting State in which the property in question 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, oil or gas wells, quarries and other places of extracting natural resources including "*timber or other forest produce*". Ships, boats and aircraft shall not be regarded as immovable property.

[50] In *Tekniskil (Sendirian) Berhard* v. *CIT* (1996) 135 CTR 292 (AAR), as cited in R. Santhanam, "Handbook on Double Taxation Avoidance Agreement Tax Planning For Collaborations", (New Delhi: Commercial Law Publishers (India) Pvt. Ltd, 2004), at. p. 610. The applicant is a company incorporated in Malaysia. It entered into a contract with a Korean Company. Such Korean company entered into agreement with ONGC for 'offshore drilling' and installation in Bombay High. The applicant company undertook to render skilled labour for an agreed consideration under the supervision of the Korean company. The question that came up for consideration was as to whether applicant is liable to pay tax under Indian Income Tax Act, for providing skilled labour. Article 7 of the Tax Treaty would apply as it is 'business profits,' but since the applicant company did not have a permanent establishment, it was argued that they are exempted.

[51] See Article 11(4) of the India-Australia Tax Treaty, Article XIII (S) of the India-Canada Tax Treaty, Article 12(6) of the India-USA Tax Treaty; which emphasizes that royalties and fees for technical services fall within the purview of business income.

in decision,[52] only gains from alienation of immovable property is considered as capital gains. Therefore, certain other properties above-mentioned are not covered under the treaty.

4. 4. India – United States Tax Treaty[53]

India- US Treaty deals with certain important aspects which makes it unique and distinct. The characteristics are:

1. The 'tax sparing method'[54] of elimination of taxation.[55] The reason for such a provision is due to the tax policies of US, which intends to give the tax benefits to its residents through its tax laws and not through tax treaty. In addition to it, investment decisions should be governed by the market considerations and not by the tax considerations. Its policy is to foster capital export neutrality.[56]

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[52] See, *CIT* v. *Kulandagan Chettiar*, n. 44.

[53] This treaty was signed on 12th September 19789 and notified vide GSR 990 (E) dated 20th December 1990; For text of treaties see, n. 3.

[54] Tax sparing method means when a source state preserves its right to tax, it is done because the activity which results in the generation of income is fully integrated in the economy of that state. It is generally accepted principle that the foreign resident should be subjected to the same conditions of activity, including taxation, as residents of the source state. Tax burden should be determined exclusively and definitely by the source state. This method has been included in many BTTs concluded by most of the home countries like Canada, Germany, France, Japan and United Kingdom. See also, Chanchal Chopra, *Foreign Investment in India: Liberalization and WTO – The Emerging Scenario,* (New Delhi: Deep and Deep publications Ltd.), 2004, at p. 265

[55] Article 25 (1) of the India-US Tax Treaty on relief from double taxation:
"1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall *allow to a resident or citizen of the United States as a credit against the United States tax on income*:

(a) the income-tax paid to India by or on behalf of such citizen or resident; and
(b) in the case of a United States company owning at least 10 per cent of the voting stock of a company which is a resident of India and from which the United States company receives dividends, the income-tax paid to India by or on behalf of the distributing company with respect to the profits out of which the dividends are paid."

For the purposes of this paragraph, the taxes referred to in paragraphs 1(b) and 2 of article 2 (Taxes Covered) shall be considered as income-taxes.

[56] See D. P. Mittal, Indian Double Taxation Agreements and Tax Laws, (New Delhi : Taxmann Allied Services Pvt. Ltd., 2001)

2. Inclusion of an unusual provision "Permanent Establishment Tax,"[57] which implies that an Indian company shall be subjected to additional tax in United States. The tax may be imposed on business profits of a company in US which represents the dividend equivalent amount and the excess of interest, if any, deductible in the United States in computing the profits of the company that are subject to tax in the United States.[58]
3. On 'Royalties'[59] the treaty follows the source principle of taxation unlike the OECD Model, which follows residence principle of taxation on royalties.[60]
4. Anti-treaty shopping provision[61] in the India-US tax treaty can be deemed to be the best example adopted to combat treaty shopping by foreign companies.

Under the anti-treaty shopping provision, the relief is limited to a person (person includes an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity[62]), other than an individual, when :

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[57] Article 14 of the India-US Tax Treaty.

[58]Under Article 6 on Immovable property, Article 12 (royalties and fees for included services) or Article 13 on capital gains.

[59] Article 12 of the India-US Tax Treaty.

[60] The Authority for Advance Ruling (AAR) at one instance held that an American company that holds majority of shares of an Indian company and such Indian company had the right to use trade marks owned in India by a Swedish company followed by another agreement to terminate the use of trademark. The royalties that it received out of such use was deemed to accrue or arise in India and therefore would be taxed in India. In re P. No. 22 of 1996 (1996) 238 ITR 99 (AAR).

[61] See Article 24 of the India-US Tax Treaty for the anti treaty shopping clause. One of the reasons for the incorporation of such provision is due to the strict policies of the US towards third country use. Article 16 of the US Model on Avoidance of Double Taxation includes a provision which denies treaty protection to a foreign controlled comprises under certain conditions. This denies all the benefits of the treaty to companies or the other entities who are residents in other country unless they are publicly quoted or owned more than 75 % by individual residents of that country, except in cases where it can be shown that the establishment of the company or entity is not for the purposes of taking advantage of the treaty.

[62] As defined in Article 3 paragraph (e) of the India-US Tax Treaty.

- More than 50% of the beneficial interest in such person is owned, directly or indirectly, by (a) one or more individual residents of one of the contracting states, or (b) other individual subject to tax in either contracting state on their worldwide incomes, or (c) citizens of US.
- The income from them is not used in substantial part, directly or indirectly, to meet liabilities to persons who are not residents of one of the contracting states or citizens of US[63].

There are few cases on the interpretation whether certain establishments can be regarded as a permanent establishment[64] or not and whether their business profits[65] could be taxed in India.[66] In the light of these characteristics it stands as an exception form rest of the tax treaties.

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[63]There are exceptions too to this general principle underlined in Article 24 which are that when (i) income is derived from the contracting state in connection with, or is incidental to, the active conduct of such person by trade or is incidental to, the active conduct of such person of trade or business; (ii) when such person is a company and is a resident of a contracting state whose principle class of shares there is substantial and regular trading on a recognised stock exchange, (iii) competent authority of state in which the income arises determines to grant benefits. D.P. Mittal, *Indian Double Taxation Agreements & Tax Laws*, (New Delhi : Taxmann Allied Services Pvt. Ltd., 2001), para 7.7.

[64] The India-US Tax treaty on permanent establishment has some addition to this concept when compared to the UN Model. Under Article 5 paragraph 2 of the treaty it includes;

"(g) a warehouse, in relation to a person providing storage facilities for others;
(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
(i) a store or premises used as sales outlet;
(j) an installation or structure used for the expropriation or exploitation of natural resources, but only if so used for a period of more than 120 days in twelve month period."

[65]The treaty defines 'business profits' as an income derived from any trade or business including income from the furnishing of services other than included services and income from rental of tangible personal property other than the property described in Article 12(3)(a). This treaty follows the rule of force of attraction as adopted in the UN Model.

[66] For example, when an American company had an undertaking for the installation of pipeline in seabed in territorial waters of India for 40 days, it was decided that it was not a permanent establishment. See *Brown and Root Inc.* v. *CIT* (1999) 237 ITR 156; see also, In re. P. No. 28 of 1999 (2000) 242 ITR 208 (AAR), in which a joint venture between an American company and Indian company lead to the former company having a permanent establishment. As any other treaty business profit and permanent establishment is defined in Article 7 and 5 of the India-US Tax Treaty.

4. 5. India – United Kingdom Tax Treaty[67]

The domestic tax law of United Kingdom, on income and corporation, is based on residence principle.[68] Any company in United Kingdom is subjected to taxation based on its residential status, depending upon 'the central management' and 'control of its business' or 'their incorporation.' A cursory glance of the provisions relating to the foreign companies and their business profits[69] shows that the treaty does not follow force of attraction rule. As per the treaty, profits that are indirectly attributable to permanent establishment are also subject to tax; since such profits arise only where the permanent establishment takes an active part in negotiating or concluding or fulfilling contracts entered into by the enterprise[70].

The 'capital gains' provision in this treaty is different, it reads thus,

> "Except as provided in Article 8 (air transport) and 9 (shipping) of this convention, such Contracting State may tax capital gains in accordance with the provisions of its domestic law."

According to this provision full right to tax the income on capital gains is given to the Contracting States and it shall be governed by their domestic tax law.. Other provisions that were subjected to interpretation are on 'business profits,' 'shipping,' and 'air transport.' It came up for consideration in *Assistant CIT* v. *International Shipping (I) (P) Ltd.*,[71] The court held that, relying on Article 7 of the agreement, a non-resident was entitled to claim the hire charges

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[67] This treaty was signed on 25th January 1993 and notified vide GSR 91 (E) dated 11th February 1994, by coming into force of this treaty the prior treaty signed on 24th December 1981 and notified vide GSR 612 (E) dared 23rd November 1981, has ceased to have effect n respect of taxes to which this treaty applies. For text of treaties see, n. 3.

[68] See Sections 334-336 of the Income and Corporation Taxes Act, 1988.

[69] Article 7 (1) of the India-UK Tax Treaty defines business profits:
"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."

[70] See D. P. Mittal, n. 56, at paragraph 13. 15.

[71] See (1994) 51 ITD 582 (Del). In this case a non-resident shipping company had entered into an agreement with the ONGC to hire a ship under a charter party for bringing machinery hired to render services to the Indian company (ONGC) for erection of offshore platforms in the Bombay High for the purpose of oil exploration. There were appeals on the basis of assessment.

paid to it and will not be taxable in India. Further, it does not have any permanent establishment in India.[72] The issues in this case related to fees for technical services.[73]

After referring to certain important provisions of the above-mentioned treaties, it would be pertinent to draw a comparative study of the treaties entered into between India and the SAARC countries, on provisions dealing with permanent establishment, associated enterprises, business profits and capital gains.

4.6. Distinction between Treaties entered with SAARC Nations.[74]

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[72] Article 5 paragraph 2 has some more elements to permanent establishment differing from the UN Model; these change are-

"(f) Premises used as a sales outlet or for receiving or soliciting orders;
(g) A Warehouse in relation to a person providing storage facilities for others;
(i) An installation or structure used for the expropriation or exploitation of natural resources,
(k) The furnishing of services, including managerial services through employees or other personnel, other than technical services (royalties and fees), if the activities continue for a period more than 90 days, or the services performed for associated enterprises which continue for a period more than 30 days, within any twelve month periods. "

[73] See Article XIII paragraph 1, 2 and 3 Royalties and fees for technical services :
1. Royalties and fees for technical services 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 and fees for technical services may also *be taxed in the Contracting State in which they arise and according to the law of that State; provided that where the royalties or fees for technical services are paid to a resident of the other Contracting State who is the beneficial owner thereof and they are paid in respect of a right or property which is first granted*, or under a contract which is signed, after the date of entry into force of this Convention, the tax so charged shall not exceed 30 per cent of the gross amount of the royalties or fees for technical services.
3. The term "royalties" as used in this article means payments of any kind including rentals received as a consideration for the use of, or the right to use:
(a) Any patent, trademark, design or model, plan, secret formula or process;
(b) Industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience; and
(c) Any copyright of literary, artistic or scientific work, cinematographic films, and films or tapes for radio or television, broadcasting, but does not include royalties or other amounts paid in respect of the operation of mines or quarries or of the extraction or removal of natural resources.
4. The term "fees for technical services" as used in this article means payments of any kind to any person, other than payments to an employee of the person making the payments and to any individual for independent personal services mentioned in Article 15 (Independent personal services), in consideration for services of a managerial, technical or consultancy nature, including the provision of services of technical or other personnel.

Sl. No.	Provision	India-Bangladesh Tax Treaty	India-Nepal Tax Treaty	India-Sri Lanka Tax Treaty
1.	Permanent Establishment	(i) The term warehouse has replaced workshop as defined in the other two treaties.	(i) it speaks of workshop and not warehouse.	(i) it speaks of workshop and not warehouse.
		(ii) paragraph 3(e) is distinct from Nepal's treaty as it includes place of advertising, supply of information, scientific research etc.	(ii) this provision is not present in this treaty.	(ii) this provision is not present in this treaty.
		(iii) Paragraph 7 is omitted in Nepal's treaty.	(iii) not present in this treaty.	(iii) not present in this treaty.
2.	Business Profits	(i) second sentence to paragraph 2 deals with computation of tax of a permanent establishment on a 'reasonable basis'.	(i) this provision is not there in the treaty.	(i) this provision is not there in the treaty.
			(ii) provision of no deduction for royalties etc, which has been paid at the head office is not present in Bangladesh treat.	(ii) provision of no deduction for royalties etc, which has been paid at the head office is not present in Bangladesh treat.

[74] It is pertinent to have such a comparative study because of the ongoing negotiations for a SAARC multilateral tax treaty.

3.	Associated Enterprises			(i) Paragraph 2 on adjustment of the amount charged on the profits of an enterprise.
4.	Capital Gains	Defined in Art. 14, it does not include immovable property, movable property or shares of a company. But it says it should arise from sale, transfer, exchange of a capital asset defined under the domestic law.	It is not defined in the treaty.	It is defined as per the UN MTC.

4. 7. Indian government's policy with respect to BTTs

In many judicial decisions it has been held that the tax treaties should be given due importance apart from emphasizing that they are highly essential for our economy's growth. In this regard it becomes necessary to know the Indian government's position or arguments with respect to BTTs. The policies adopted are that -

- In order to promote India's economic and industrial development it is essential to make Indian taxes considerably relieved.
- To promote coordination among Indian taxation and foreign tax legislation to make trading within India for both Indian and foreign companies simpler.
- These agreements intend to permit Indian authorities to cooperate with foreign tax administration.

- These treaties are a compromise between taxation at source and taxation at residence. Agreements concluded after 1976 strictly follow source rule.
- To attain highest possible incentive effect, Indian government is ready to grant full exemption to certain items of income and capital. Therefore, tax revenues are sacrificed in exchange for the economic and industrial development of the country to permit free flow of technology in India.
- Temporary revenue loss is accepted when trying to seek long-term economic benefits and profits.[75]

4. 8. Conclusion

On analyzing these treaties one can find that though there are problems with other treaty interpretation yet these treaties play a significant role in increasing the gross revenue of India. For example in the *India-Mauritius Tax Treaty case*, known as *Azadi Bachao Andolan case*, it was specified by the Indian judiciary that treaty shopping is also a mechanism which certain developing countries have been following and is legal. Also in another case when the investor company emphasized that it is very lengthy procedures, the court held that they ought to follow while it is very lenient in other countries, such argument was accepted by the Indian courts.

It could be seen that other treaties analysed do not contain any anti treaty shopping provision or stricter laws as emphasized in India-US Tax Treaty so that certain investments would directly come to India. But on careful examination of the Indian government's policies reveals that India needs investment in order to attain economic growth and industrial development.

The analysis of SAARC treaties stands relevant because there have been a movement to negotiate for a SAARC multilateral tax treaty. Apart from these, one of the major factors relevant for implementation of the tax treaty is its overriding effect over domestic tax law. This means that Indian judiciary also supports these factors because they are adopted by virtue of government's

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[75] See D. P. Mittal, n. 56, at paragraph 2. 12.

policies. Thus, in summary, once a treaty is entered into, it becomes binding as a domestic legislation in India. Moreover, these treaties when subjected to interpretation in the courts they emphasis on the importance of the treaties and the overriding effect of these treaties over Indian Income Tax Act, 1961.

Chapter V

Conclusion

CHAPTER V
CONCLUSION

The need to avoid double taxation of the same money, of the same person, during the same period, was remedied by the framing of tax treaties both at the multilateral and at the bilateral level. The main purpose of any tax treaty is to avoid double taxation and to avoid fiscal evasion *vis-a-vis* promoting foreign investment. It emphasizes on the importance of international cooperation through exchange of information, assistance in collection and mutual agreement procedure. The three main actors of the tax treaties are the home country, host country and the foreign investor.

An analysis of the tax treaties at the *multilateral level* shows the necessity for the same depending upon the *economic status* of states. There are two MTCs at the multilateral level, namely the OECD MTC and the UN MTC, followed widely by the developed and the developing countries respectively. Both the MTCs reflect the economic interests of the concerned states. An overview of these conventions reveals the distinctiveness of these conventions in their approach, of contents and the objectives despite of its seemingly identical form.

The negotiating history of both the MTCs reveals the significance of tax treaties in an era of increase of trade and commerce. The period of negotiation of the OECD MTC started much earlier when compared to the UN MTC, accentuating the relevance attributed to the concept of economic development, economic self-determination etc. were considered important by the developed and developing countries. In practice, both the MTCs differ in principle of taxation and methods for elimination of double taxation. The OECD Model that was adopted and enacted for the capital exporting countries, is based upon the resident principle of taxation depending upon the residence of the investor. They generally followed the tax exemption method of eliminating double taxation for the above mentioned reason.

On the other hand, the UN Model relied on source principle of taxation for two reasons namely, the developing countries were capital importing countries and

also that their prior experience (before the UN Model) of following residence principle as incorporated in the OECD MTC had lead to major revenue losses to them because income always flows towards the resident country and not the source country (host country).

BTTs started flourishing during the same period as when the states started their work for the establishment of a model or a framework tax convention. As far as a state is concerned, BTTs play a crucial role in achieving their developmental goals, as these tax treaties are one of the major determinants of FDI. An investor be it an individual or companies (including TNCs) decides to invest in developing country, only when they are assured of the certainty of the tax laws of the host country. Therefore, if a country has a BTT with the investor's home country, it benefits the investor under three major aspects, for having certainty regarding tax laws, affirmation to follow internationally accepted standards of dispute settlement and transfer pricing, and also in providing assurance to the investor regarding the information exchanging process whenever there is an issue or a dispute.

Throughout this study there has been an emphasis on the definitional interpretation of the concepts like – 'permanent establishment', 'residence', 'business profits,' 'associated enterprises' and 'capital gains' under few Indian BTTs in order to delve into the discrepancies of the tax treaty. Further, these concepts denote the fact that companies as investors cannot be negated since they are the major source of FDI, than individuals. In this regard, one should also note how these concepts are relevant to signify the importance of companies and their subsidies, any lacunas in the tax treaties are generally interpreted by them in their favour. This is evident and an undisputed fact that these companies adopt various methods to avoid double taxation in order to reap profits. Methods followed by the companies to avoid or evade tax are through transfer pricing, thin capitalization, shifting of profits to their associated enterprises etc. The OECD had classified certain countries as tax havens and harmful Preferential tax regime, which had practiced low/nominal tax rates in order to attract foreign investment, which adversely affected the interests of the host country of the investor. This reveals that

the Investor Company or TNC is interested solely in reaping profits and is not a means of economic development either to the home or the host country. Therefore, if the host country is a developing country, such amount of avoidance of taxation though meager for the TNcs is still high and substantial enough for the host developing country to cause revenue loss.

The OECD Report, has been criticized by many states arguing that it is a matter of clear interference with the sovereign rights of states. It is further argued that the recommendations of the OECD has binding effect only among its member states, and therefore is not the appropriate authority to deal and dictate such matters. The contention, which is highlighted here, is the erosion of the concept of economic sovereignty or fiscal sovereignty (which is absolute) of a state.

At the multilateral level, there are ongoing discussions for the formation or the creation of an international Tax organization, emphasising on a multilateral tax treaty under a single uniform international institution along with a World Tax Court. It is hereby submitted that such an establishment would be detrimental to the interests of the developing countries because it would reopen the whole debate for the necessity to have a tax treaty. Once it is accepted, the tax structure and the 'fiscal sovereignty' of a state would entirely be ruptured. The reason for such a conclusion is underlined in the previous experience with the OECD regarding its reports, blacklisting certain countries for conducting harmful tax competition. It is thus, not advisable to accept an international body to regulate and frame the tax laws of the states by setting an 'internationally accepted rules on tax matter,' since fiscal matters are areas through which the states could uphold the interests while negotiating a BTT. Therefore, it is emphasized at this juncture, to accept bilateralism with respect to tax treaties since it is an area where any country, particularly a developing country can exercise their liberty to bargain for a better position.

Thus it is submitted that the developing countries should not encourage a uniform multilateral tax treaty, but emphasise on entering into BTTs in order to protect their economic interest. This study, has examined India's position in

relation to BTTs, apart from dealing with the concept of 'avoidance of double taxation' at the multilateral level. In India there has been major changes in foreign investment promotion policies after the inception of the NIP (New Industrial Policy, 1991). This has lead to the liberalization of its economy. BTTs are implemented in India through Section 90 of the Indian Income Tax Act, 1961 which is modeled on Section 49 A of the Indian Income Tax Act, 1922. This shows that the need to have a DTAC was considered very significant during the pre-independence period itself. It is also pertinent to note that this issue was very crucial for India; and Indian government had given more importance to it by dealing with this issue, from 1922 onwards.

The Indian domestic tax law accentuates that the treaty will be given more importance over a domestic legislation, (that is, Indian Income Tax Act) whenever it is subject to interpretation. According to the Indian Constitution, an international agreement comes into force only after its enactment by the Indian Parliament through ratification. But, in the case of BTTs, it becomes domestic law as soon as it is concluded by the Contracting States and notified by the Central Government.

India has dealt with this concept by entering into various BTTs with other countries. It follows two approaches whenever a BTT is signed, depending upon the other Contracting State. One of the approaches is to attract foreign investment while concluding a BTT with developed countries and maintain a *quid pro quo* relationship with any other developing country. This is evident upon an examination of the tax treaties. For example, a case study of the Indian BTTs with its top foreign investors including US, UK, Mauritius and Malaysia shows that they are intended to promote trade and investment. In these BTTs the terms like permanent establishment and residence is exhaustive so as to include even a small business activity within the purview of permanent establishment. These BTTs read with the judicial decisions of the Indian courts infer that there are more chances of declaring a business activity to be not a permanent establishment, and thereby exempting them from taxation in India. The idea behind such an exemption is *not to tax the taxpayer twice on the same income*, during the same period.

A dispute on the investment by FIIs through Mauritius examined elsewhere in this study, clarifies the above statement. In that case, on the interpretation of the India-Mauritius BTT the court decided that the tax residency certificate issued by the Mauritius Offshore Business Authority is valid enough for claiming exemption by the FIIs from paying tax in India. At this instance, it is pertinent to note that such a relaxation in tax treaty via issuance of a Circular (issued by CBDT) had lead to major investments in India during that period. Another significant aspect of this case was when the court stated that treaty shopping is not illegal because few developing countries are following it in order to attract foreign investment.

India's treaty with SAARC countries and three ASEAN countries lays down the criteria for taxing a business activity, if it could satisfy that it is conducting business in India for a minimum period of 183 days. With certain developed countries like Australia, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland and UK the time period is 6 months and the treaty with US mandates the same to be 120 days. India has adopted this method in its tax treaties in order to permit any foreign investor to 'establish' in India within a short period thereby permitting them to trade freely and easily with India. For example, an examination of the India-US BTT which emphasis on 120 days period for such establishment, a lesser time period as compared to other countries through the respective BTTs (SAARC, ASEAN and certain other developed countries). This could be considered as one of the reasons why US is a major foreign investor in India.

Among the SAARC countries there was a movement to establish SAARC Multilateral Tax Treaty. Having examined these treaties, it becomes clear that there are differences existing among them –

- India-Bangladesh Treaty defines capital gains differing from rest of the treaties as it excludes movable, immovable property and shares from its definition, wherein
- The India-Nepal Treaty does not define the term at all. Therefore in the light of these differences forming a regional multilateral tax treaty is acceptable

since it can be used as a model for concluding a *model framework convention on avoidance of double taxation between developing countries.*

Attempts have been made in this study to put forth few suggestions to consider the avoidance of the flaws in the tax treaties, which are;

- A source state should adopt the rule of 120 days (of residence) instead of 183 days, in order to term the business carried out by any establishment as a permanent establishment. This would lead to making them liable to taxation in the source country.
- The 'head and brain' rule along with the place of effective control and management rule should be the basis for the taxation of a permanent establishment, since no investor shall take shelter in investing in India thorough other countries.
- There should be effective cooperation that is, whenever there is any problem as to the taxation of a permanent establishment, the country which acts as a channel should be informed to exchange the information regarding the companies activities, so that they do not avoid paying tax and shall not bring loss in the revenue, which might be meager but substantially high amount. Such laxity should not be given keeping into account long term gains. Therefore, it is necessary that a developing country like India, should make no discrepancies in collecting and levying tax since its ultimate motive is attainment of economic development.

To sum up, a review of the study depicts that in order to preserve the concept of economic sovereignty and equality during the negotiations of the BTTs it is essential to support and promote bilateralism since it gives the nations, especially the developing countries the liberty to negotiate keeping in view their economic development as a goal. In the Indian context, this is the only area in which international agreements are implemented and given a special status considering it to be a *lex specialis* so that there is proper application and interpretation of the tax treaties and the taxpayer is not placed at a disadvantageous position.

Appendices

Appendix I

List of Comprehensive BTTs Signed By India

APPENDIX I

List of Comprehensive BTTS Signed By India

Sl. No.	Country	Concerning	Concluded
1.	Algeria	income	25.01.2001
2.	Armenia	income	31.10.2003
3.	Australia	income	25.07.1991
4.	Austria	income	08.11.1999
5.	Bangladesh	income	27.08.1991
6.	Belarus	income	27.09.1997
7.	Belgium	income	26.04.1993
8.	Brazil	income	26.04.1988
9.	Bulgaria	income, capital	26.05.1994
10.	Canada	income, capital	11.01.1996
11.	China	income	18.07.1994
12.	Cyprus	income, capital	13.06.1994
13.	Czech Republic	income	01.10.1998
14.	Denmark	income, capital	08.03.1989
15.	Egypt	income	20.02.1969
16.	Finland	income	
	Treaty	income, capital	10.06.1983
	Protocol	income, capital	09.04.1997
17.	France	income, capital	29.09.1992
18.	Germany	income, capital	19.06.1995
19.	Greece	income	11.02.1965
20.	Hungary	income	30.10.1986
21.	Indonesia	income	07.08.1987
22.	Ireland	income	06.11.2000
23.	Israel	income, capital	29.01.1996

24.	Italy	income	19.02.1993
25.	Japan	income	07.03.1989
26.	Jordan	income	20.04.1999
27.	Kazakhstan	income, capital	09.12.1996
28.	Kenya	income	12.04.1985
29.	Korea	income	19.07.1985
30.	Kyrgyz Stan	income	13.04.1999
31.	Libya	income	02.03.1981
32.	Malaysia		
	Treaty	income	25.10.1976
	New Treaty	income	14.05.2001
33.	Malta	income	28.09.1994
34.	Mauritius	income	24.08.1982
35.	Mongolia	income, capital	22.02.1994
36.	Morocco	income	30.10.1998
37.	Namibia	income	15.02.1997
38.	Nepal	income	18.01.1987
39.	Netherlands	income, capital	30.07.1988
40.	New Zealand		
	Treaty	income	17.10.1986
	Protocol	income	29.08.1996
	Protocol	income	21.06.1999
41.	Norway	income, capital	31.12.1986
42.	Oman	income	02.04.1997
43.	Philippines	income	12.02.1990
44.	Poland	income	21.06.1989
45.	Portugal	income	11.09.1998
46.	Qatar	income	07.04.1999
47.	Romania	income	10.03.1987
48.	Russia	income	25.03.1997

49.	Sierra Leone	income	
50.	Singapore	income	24.01.1994
51.	Slovak Republic	income	27.01.1986
52.	South Africa	income	04.12.1996
53.	Spain	income, capital	08.02.1993
54.	Sri Lanka	income, capital	27.01.1982
55.	Sweden	income, capital	24.06.1997
56.	Switzerland		
	Treaty	income	02.11.1994
	Protocol	income	16.02.2000
57.	Syria	income	06.02.1984
58.	Tanzania	income	05.09.1979
59.	Thailand	income	22.03.1985
60.	Trinidad and Tobago	income	08.02.1999
61.	Turkey	income	31.01.1995
62.	Turkmenistan	income, capital	25.02.1997
63.	Ukraine	income	07.04.1999
64.	USSR	income	20.11.1988
65.	UAE	income, capital	29.04.1992
66.	United Kingdom		
	Treaty	income	25.01.1993
	Treaty	inheritances	03.04.1956
67.	United States	income	12.09.1989
68.	Uzbekistan	income, capital	29.07.1993
69.	Vietnam	income	07.09.1994
70.	Zambia.	Income	05.06.1981

Appendix II

Revised United Nations Model Double Taxation Convention between Developed and Developing Countries, 2001

APPENDIX II

Revised United Nations Model Double Taxation Convention between Developed and Developing Countries, 2001.

1 States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.
2 The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of the Contracting States.

TITLE OF THE CONVENTION –

Convention between (State A) and (State B) with respect to taxes on income and on capital1

PREAMBLE OF THE CONVENTION

Chapter I - SCOPE OF THE CONVENTION

Article 1- PERSONS COVERED

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

Article 2 - TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:
(a) (in State A): ....
(b) (in State B): ....
4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the contracting States shall notify each other of significant changes made to their tax law.

CHAPTER II - DEFINITIONS

Article 3 -GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:
(a) The term "person" includes an individual, a company and any other body of persons;

(b) The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;
(c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
(d) The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
(e) The term "competent authority" means:
(i) (In State A): ....
(ii) (In State B): ....
(f) The term "national" means:
(i) Any individual possessing the nationality of a Contracting State
(ii) Any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.
2. 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 the 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 the term under other laws of that State.

Article 4 - RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
(a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
(b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
(c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

(d) If he is a national of both 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 provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the 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 an enterprise is wholly or partly carried on.
2. The term "permanent establishment" includes especially: (a) A place of management; (b) A branch; (c) An office; (d) A factory; (e) A workshop; (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. The term "permanent establishment" also encompasses: (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.
4. 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 goods or 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 p'ace of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. 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, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. 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 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 derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question 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, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall also 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 (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.
2. Subject to the provisions of paragraph 3, 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.
3. In the determination of 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. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for managemei t, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.
4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an

apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.
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 of 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.
(NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations).

Article 8 - SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 (alternative A)

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. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (alternative B)

1. Profits from the operation of 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. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the over-all net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations).

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9 - ASSOCIATED ENTERPRISES

1. 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.
2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and 'he competent authorities of the Contracting States shall, if necessary, consult each other.
3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

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 according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.
This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.
3. The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' 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 State of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 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 case the provisions of article 7 or article 14, as the case may be, shall apply.
5. 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, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the

Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. 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.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner 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 (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is 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 or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.
6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, 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 beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such 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 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 laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

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, or films or tapes used 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 beneficial owner 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 (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases 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 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 or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.
6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, 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 beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such 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 derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.
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 with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:
(1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.
(2) For the purposes of this paragraph,"principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty percent of the aggregate value of all assets owned by the company, partnership, trust or estate.
5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of __ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.
6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14 - INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:
(a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
(b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.
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, 18 and 19, 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 State.
2. Notwithstanding the provisions of paragraph 1, 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 the 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 any twelve-month period commencing or ending in the fiscal year concerned; 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 derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16 - DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. 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 State.
2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17- ARTISTES AND SPORTSPERSONS

1. Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.
2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

Article 18 - PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.
2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 (alternative B)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.
2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.
3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 19 -GOVERNMENT SERVICE

1. (a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:

(i) Is a national of that State; or (ii) Did not become a resident of that State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.

3. The provisions of articles 15, 16, 17 and 18 shall apply to salaries, wages and other similar remuneration, and to pensions, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20- STUDENTS

Payments which a student or business trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21 - OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that 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.
3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

Chapter IV - TAXATION OF CAPITAL

Article 22 - CAPITAL

1. Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by 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 by 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, may be taxed in that other State.
3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

[4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State].

(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all

other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located).

Chapter V - METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23 A - EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of articles 10, 11 and 12, may be taxed in the other Contracting State, the first mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such
resident, take into account the exempted income or capital.

Article 23 B - CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Chapter VI - SPECIAL PROVISIONS

Article 24 - NON-DISCRIMINATION

1. 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, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either 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 the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. 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. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
5. 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 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 the first-mentioned State are or may be subjected.
6. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

Article 25 - MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of 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 a satisfactory 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 which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law 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 the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

Article 26 - EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.
2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
(a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) To supply information which is 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 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 (ordre public).

Article 27- MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Chapter VII - FINAL PROVISIONS

Article 28 -ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at ________ as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

(a) (In State A): ....
(b) (In State B): ....

Article 29 -TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ____.
In such event, the Convention shall cease to have effect:
(a) (In State A): ....
(b) (In State B): ....
TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

Select Bibliography

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