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Treaty Shopping

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ABSTRACT:

Double tax treaties are international agreements between sovereign states that are governed by the Vienna Convention on the Law of Treaties (VCLT) general international law standards. The main objectives of tax treaties addressed is to avoid or eliminate double taxation as well as to prevent tax evasion. The double taxation concept has always been seen as one of the major obstacles in international trade. To be eligible for the benefits of the Double Taxation Avoidance Agreement (DTAA) between two nations, a person must be a resident of one of the countries. Treaty Shopping occurs when a resident of a third nation takes advantage of a DTAA between two countries. The resident of a third nation obtains the residency of a country in order to profit from the DTAA of that country with the other country, similar to shopping. Countries are engaged in an effort to design anti-abuse rules to prevent the avoidance of taxation, specifically the design of rules to prevent the circumvention of the residence principle in order to obtain treaty benefits that are not supposed to be granted to taxpayers that are not residents of the contracting states. In this research, scholar will analyze the rules designed by the tax treaty regime in order to prevent treaty shopping. The Anti Treaty Shopping mechanisms that would be presented are the Beneficial Ownership concept, the Limitation on Benefits Provisions and the Principal Purpose Test.

KEYWORDS:

Abuse of rights, Tax Avoidance, Base Erosion & Profit Shifting, Treaty shopping, Limitation on Benefit, Principle purpose test, Beneficial Ownership, Anti Avoidance Rules, Minimum Standard.

CHAPTER – 1

INTRODUCTION

In recent years, the business world has witnessed a continuing and positively increasing wave of restructuring processes of companies in the transnational trade arena. To achieve better outcome in a shorter duration, the companies are influenced by the tax edges offered by countries seeking to draw foreign investment. This not only helps the business but also the country to develop their individual economy.

The decision to invest in a foreign country is influenced by the tax treaties it has in force with the other countries. These treaties are framed after having numerous negotiations based on the economy of the countries and hence its benefits are available only to the residents of those countries, parties to the tax treaty. However, in reality, the benefits of the tax treaty between two countries are enjoyed by a resident of third country which results in abuse of the tax treaty, commonly known as treaty shopping.

Treaty shopping occurs when a person tries to get indirect access to the benefits of a tax treaty between two countries without being a resident of either of them. A person who is a non-resident of a country that is a party to a tax agreement may attempt to receive benefits that a tax agreement gives to a resident of that jurisdiction through a variety of methods. Taxpayers who engage in treaty shopping and other forms of treaty abuse jeopardise tax sovereignty.

To combat and prevent treaty abuse, countries have adopted strategies like the idea of abuse of rights, domestic judicial anti-avoidance principles, domestic legislation that features general or specific anti-avoidance rules to deny treaty edges. From a tax treaty perspective countries have enforced specific anti-avoidance provisions such as abuse of rights doctrine, the Limitation on Benefits provisions (LOB), the Principle Purpose Test (PPT), which are presently been projected to be incorporated within the Organisation for Economic Co-operation and Development (OECD) Model Conventions in Base Erosion and Profit Shifting (BEPS) Action 6 so as to prevent treaty abuse.

As mentioned, to deal with the study of pact abuse it is necessary to explore the tax pact regime, so as to produce a broad information of the most aspects of the system, like the tax treaty construct, the objectives of the regime, the treaty principles and also the general framework of the treaty rules. Only after this is understood, it will be reasonable to judge the tax treaty abuse, particularly the use of tax treaties in foreign jurisdictions to claim unjust benefits. Once these are done, it will be rational to measure the assorted set of rules adopted within the tax treaties to tackle the ways of treaty abuse.

One of the most serious causes of BEPS concerns is treaty misuse. It is unfavourable for a variety of reasons, including benefits agreed between parties to the treaty are extended economically to inhabitants of a third jurisdiction in ways that the parties did not anticipate. As a result, the concept of reciprocity is violated, and the balance of concessions made by the parties is shifted. Income may be exempt from taxation entirely or subjected to insufficient taxation in ways that the parties did not intend and because citizens of the jurisdiction of residence might indirectly obtain treaty advantages from the jurisdiction of source without the jurisdiction of residence providing reciprocal benefits, the jurisdiction of residence has less motivation to engage into a tax treaty with the jurisdiction of source.

Treaty shopping concerns are not new. The concept of “beneficial owner” was introduced into the OECD Model Tax Convention dividends, interest, and royalties articles in 1977 to clarify the meaning of the words “paid to” and deal with simple treaty-shopping situations in which income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes (such as an agent or nominee). In 1977, the OECD Model's Commentary on Article 1 was also amended to include a section on

the inappropriate use of tax treaties. The Committee on Fiscal Affairs (CFA) issued two reports in 1986: Double Taxation and the Use of Base Companies and Double Taxation and the Use of Conduit Companies are two different types of double taxation. The Committee's report, Restricting Entitlement to Treaty Benefits, was released in 2002.

Several times, most recently in 2003, the Commentary on Article 1 was updated to provide model measures that nations might employ to combat treaty shopping. A examination of jurisdictional procedures reveals that they have attempted to counter treaty shopping in the past, employing a variety of techniques. Specific anti-abuse measures based on the legal nature, ownership, and general activities of inhabitants of a jurisdiction party to a tax agreement have been used by some others have advocated for a broad anti-abuse rule based on the nature of the transactions or arrangements.

BEPS Action 6 seeks to tackle treaty shopping through treaty provisions, the adoption of which constitutes part of a minimum standard(s) agreed to by members of the BEPS Inclusive Framework. It also contains particular guidelines and advice for dealing with various types of treaty abuse. Action 6 highlights tax policy factors that governments should examine before entering into a tax agreement. Over the last few decades, bilateral tax treaties signed virtually by almost every country in the world have worked to eliminate damaging double taxation and reduce barriers to cross-border commerce in products and services, as well as money, technology, and people movements.

1.1 SCOPE AND OBJECTIVES OF THE STUDY

This research is carried out with the following scope and objectives, namely-

1. To analyse and understand the concept of treaty abuse.
2. To examine the measures to prohibit the tax treaty abuse.
3. To elucidate how the LOB is the well planned measure to prohibit tax treaty shopping by the tax payers.
4. To analyze the role of the PPT rule in combatting tax abusive practices.
5. To evaluate whether the execution of the PPT rule lead to unpredictabilty among the tax payers.
6. To compare the LOB & PPT rule, so as to determine the best tool for preventing tax avoidance through treaty shopping.

1.2 REVIEW OF LITERATURE

Treaty shopping is defined by **Roy Rohatgi** in his book *Basic International Law*¹ as the routing of revenue originating in one country to a person in another country via an intermediate country in order to get an unexpected tax benefit from tax treaties. It occurs when a taxpayer resident in a third nation takes use of treaty benefits that would not be available to a regular taxpayer.

¹ Roy Rohatgi, II, *Basic International Taxation*, 165 (Taxmann Allied Services (P.) Ltd., New Delhi, 2nd, 2007).

By citing the decision of the Supreme Court in *Azadi Bachoo Andolan Case*(2003), the author found that there was no inherent anti-abuse provision in Indian tax treaties, and hence the denial of treaty rights requires an explicit limitation on benefits clause in the treaty itself. He reasoned that treaty shopping was not prohibited.

According to him, using tax treaties to get treaty advantages not accessible directly to third-country citizens should be legal as long as it is not expressly forbidden by treaty provisions or basic international law. Every treaty is obligatory on the parties and must be carried out in good faith in accordance with the concept of "pacta sunt servanda" (VCLT Article 26). VCLT Article 27 stipulates that a nation may not use its domestic law to justify its failure to carry out a treaty. Treaty shopping should not be considered abusive unless it is expressly prohibited by a bilaterally negotiated treaty.²

Anna Nizioeka, Damian Doboszb in their article, *"The Remedies for treaty shopping in view of current legislation"*³ referred to Tax heavens as areas with extremely low tax rates. They provided examples, according to the academics.: Company A intends to send dividends to Company B, for example, and the transaction is taxed at a 15% tax rate under the agreement on the avoidance of double taxation between countries A and B. However, the transaction is taxable at a 2% tax rate under the agreement on the avoidance of double taxation between country A and country C, and at a 5% tax rate under the convention on the avoidance of double taxation between country C and B. As a result, corporate entities are adopting "treaty shopping" tactics and becoming "treaty shoppers" while deciding for firm C to be engaged in the transaction between A and B only to pay a 7 percent tax rate (2 percent + 5 percent). The growth of globalisation was the major cause for the "treaty shopping" method's rising popularity. The word "globalisation" refers not just to the region covered by European countries and the United States of America, but also to tiny islands (tax havens) that "treaty shoppers" commonly utilise to reduce their tax burden.

In his article *Abuse of Double Taxation Avoidance Agreement by Treaty Shopping in India*⁴, Dr. Sanjay Kumar Yadav believes that the DTAA with other nations has to be amended to include explicit provisions in the treaty prohibiting the misuse of the treaty by a resident of a third country. The General Anti-Avoidance Rules (GAAR) granted tax authorities the authority to strike down transactions that lacked business or commercial character and were intended to avoid paying taxes. According to him, adopting anti-abuse provisions in tax treaties may not be enough to handle all tax avoidance tactics, which must be addressed through domestic anti-avoidance regulations. According to the study, there will be no need to use GAAR if a case of avoidance is adequately handled by the tax treaty's LOB rules.

² Ibid at 183.

³Anna Nizioeka& Damian Doboszb,"The Remedies for treaty shopping in view of current legislation", *International Scientific Journal*,345,(2018).

⁴ Dr. Sanjay Kumar Yadav, "Abuse of Double Taxation Avoidance Agreement by Treaty Shopping in India", 23,10, *IOSR Journal*,72,(2018).

In his article *Tax Base Erosion and Profit Shifting in Africa – Part 2: A Critique of Some Priority OECD Actions from an African Perspective*,⁵ Annet Wanyana Oguttu views that enacting anti-abuse clauses in tax treaties may not be sufficient to cover all tax avoidance strategies, which must be handled through domestic anti-avoidance legislation. According to the research, if a case of avoidance is sufficiently handled by the tax treaty's LOB regulations, there will be no need to apply GAAR. Although he stated that the OECD and UN Model Tax Convention(MTC) comments maintain that there is no conflict between DTAA provisions and local anti-avoidance laws because the latter only establish the facts to which DTAA's apply. Because a DTAA is a contract between the contracting states, its terms are typically deemed to prevail above domestic law. He believes that in order to avoid treaty shopping, countries must implement domestic anti-abuse measures that reflect the anti-abuse requirements in their DTAA's.

Michael Lang in his article *Tax Treaty Entitlement*⁶, stated that the PPT was intended as a general anti-abuse criterion applicable in cases when a person seeks to evade limits imposed by the treaty itself, taking into account the changes detailed in the BEPS Action 6 Final Report. He supports the argument that the subjective test of the PPT must be strictly construed to target only arrangements and transactions with the aim of circumventing tax treaties based on the circumstances in which it was established. By putting down the treaty shopping, the circumvention of treaty provisions refers to evading the articles that regulate access to the treaty. However, it would be incorrect to say that a taxpayer is evading treaty or domestic law restrictions where the relevant laws' object and purpose give choices for a taxpayer's behaviour, and he selects the most advantageous option for tax reasons. Simultaneously, he emphasised that the goal and purpose of the applicable tax treaties are the vital factors in determining whether a transaction or arrangement is abusive.

1.3 RESEARCH PROBLEM

Eventhough Tax avoidance is not a crime in itself since it comes to the design of structures to circumvent or minimize taxation charges or avoidance of taxation. Treaty shopping is one of the tool for tax avoidance. Treaty shopping affects the source country by loss of revenue by restricting the rate of its withholding tax in comparison to the rate of tax that has to be paid as per the DTAA. The very object of a tax treaty is to prevent treaty shopping as it violates a tax treaty's reciprocity and also increases the third countries income with minimal or nil economic activities carried from there.

1.4 HYPOTHESIS

In a BEPS world, the LOB clause have 5 tests, which is not sufficient to determine those tax payer who are worth of benefiting from the treaty, but subjective test and purpose test contained under PPT is the OECD's gold standard for preventing treaty shopping. Therefore the PPT rule has a high subjective component that allows tax authorities to address tax abusive schemes that the LOB clause could not address,

⁵ Annet Wanyana Oguttu ,”Tax Base Erosion and Profit Shifting in Africa”2:A Critique of Some Priority OECD Actions from an African Perspective,*Institute of Development Studies*,64(2017).

⁶ Michael Lang et al,*Tax Treaty Entitlement*,36(IBFD,Netherland, May 2019).

but can create certainty among taxpayers, as well as an objective test that is met as long as the grant of the treaty benefit is consistent with the object and purpose of the treaty provision.

1.5 RESEARCH QUESTIONS

The researcher seeks to answer the following questions:

1. Whether the five tests under the LOB provisions can be a complete test in determining whether the taxpayer involves in a treaty abuse or not?
2. What are the anti-treaty shopping mechanism and which one is to be added to prevent treaty shopping?
3. What are the consequences of PPT rule?
4. Whether Subjective test and Objective test is sufficient for preventing the treaty shopping by the tax payer?
5. Whether the object of anti-treaty shopping rules are to be interpreted narrowly and technically or with regard to abusive intentions on the part of the taxpayer?

1.6 RESEARCH METHODOLOGY

The researcher has adopted the doctrinal method to carry out the research and used the historical, analytical and critical methods of data interpretation. The primary sources of data include International Agreements, Recommendations by International Organisations like Financial Stability Forum, International Monetary Fund, Financial Action Task Force, Organisation for Economic Co-operation and Development, national legislations like the Constitution of India, Prevention of Money Laundering Act, Foreign Exchange Management Act, Circulars and Notifications issued by the RBI from time to time. The secondary sources of data include books and articles published in journals and websites.

CHAPTER – 2

UNDERSTANDING TAX TREATIES

In order to address the study of treaty abuse, it is necessary to first investigate the tax treaty regime in order to gain a broad understanding of the system's main components, such as the tax treaty concept, the regime's objectives, treaty principles, and the general framework of treaty rules. Following that, it will be easy to assess tax treaty abuse, namely the use of tax treaties as a tactic to avoid or reduce source taxation in foreign jurisdictions. Finally, it will become feasible to assess the numerous sets of regulations that have been implemented in tax treaties to combat treaty abuse.

In this chapter the researcher discusses the notion of tax treaties and provides an insight to the brief history of the system. Following that the basic goals of bilateral tax treaties, the key treaty regulations, and the principles that govern the tax treaty regime's structure. The goal of this chapter is to provide the skills one needs to properly handle the concepts of tax evasion and treaty abuse and understand how they might affect

the tax treaties. This study can also provide the tools to distinguish between legal tax planning through structures arising from the application of tax treaty rules and treaty abuse.

2.1 CONCEPT OF TAX TREATIES

Double tax treaties are international agreements between sovereign states that are governed by the VCLT general international law standards. Bilateral tax treaties, in general, grant rights and impose responsibilities on Contracting States in order to foster better market conditions and, as a result, benefit the states' taxpayers.

The duty to begin proceedings under each country's domestic law comes as the first step, after the treaty is signed by the Contracting States. In most democratic nations, the treaty must be debated and ratified by each Contracting State's parliament in order to be legitimate. Otherwise, it would be null and void under the VCLT's Article 46(2)⁷. The discussion on the treaty must be ended by an exchange of instruments, also known as ratification, which is generally done by the president or leader of the relevant government, following the debate in parliament. After which the treaty becomes legally enforceable under international law, and the treaty's advantages can be extended to citizens of the Contracting States.

As will be explained in more depth, one of the main concerns of the tax treaty system is to ensure that treaty benefits only be granted to the residents of the contracting states, never to third parties, and that there must be a strong economic connection of the residents with the countries involved in a tax treaty. This issue has a special relevance for the system, due to the fact that residents of third countries in order to obtain treaty benefits, structure their transactions in such a way to circumvent the residence requirement to obtain treaty benefits, by interposing the so called conduit companies in one of the contracting states, which as a general rule are companies without any economic substance, incorporated with the main or sole purpose to gain benefits from a tax treaty.

To analyze the OECD Model Convention approach to prevent a third country resident to invoke a tax treaty benefit, contained in articles 10, 11 and 12 of the Model Convention⁸. In a broad sense, these provisions allow the reduction of withholding taxes levied by the source state on passive incomes such as dividends, interests and royalties that flows from the source state to a resident of the other contracting state. In order to achieve that goal, the OECD Model Convention requires the recipient of the income to be the beneficial owner of the income.

It is important to fully understand that under the tax treaty system, the Contracting States will not in any way render their tax sovereignty. The tax treaty system acknowledges that each Contracting State will apply its own domestic tax law. It is worth noting that tax treaties will not serve as instruments to solve conflicts of tax laws between the States or allocate tax jurisdiction. Tax treaties are a mechanism to avoid double taxation through the limitation of tax claims for certain items of income, in situations where both

⁷ United Nations, *Vienna Convention on the Law of Treaties*, 23 May 1969, United Nations, Treaty Series, 1155, 331, available at: <https://www.refworld.org/docid/3ae6b3a10.html> [accessed 9 November 2021].

⁸ OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* 2017, OECD Publishing, Paris, 10-14, available at <https://doi.org/10.1787/g2g972ee-en>.

Contracting States may claim the right to tax. The residence and source principles are the leading concepts of the tax treaty regime and are the base of the instruments and rules to determine the manner in which taxing rights are distributed between the Contracting States in order to avoid double taxation.

As we will study in more depth later on in this study, by signing a tax treaty, the Contracting States agree not to levy taxes in some specific occasions, or tax with limitations on the tax rate for example, establishing rules to determine when a State reserves the right to tax either fully or partly a taxable income.

As mentioned above, the tax treaty imposes limits to the domestic taxation, through the application of a tax treaty a Contracting State will renounce its tax right in favour of the other Contracting State by basically granting an exemption either by the exemption system or the credit system (Art. 23A or 23B OECD Model Convention)⁹, method that must be agreed upon mutual consent by the Contracting States.

According to the above, one have to conclude that tax treaties do not create taxing rights or claims for any of the Contracting States other than those tax rights that already exist under domestic tax law.

2.2 FUNCTIONS OF TAX TREATIES

In the preamble to tax treaties one of the objectives addressed is to avoid or eliminate double taxation as well as to prevent tax evasion. The double taxation concept has always been seen as one of the major obstacles in international trade. According to Professor Van Weeghel “the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same item of income for identical periods”¹⁰ is called double taxation. The principles of residence and source are fundamental to the construction of the treaty system, and their application determine the manner in which the taxing rights are allocated between the Contracting States to avoid or minimize double taxation

- **Residence principle:** As a general rule the vast majority of countries in order to determine the tax liability of its residents, apply the worldwide income, based on those who are residents in their territory . Residence is determined by the strong connections with the state, which are used to justify the unlimited tax liability of the subject. The reasoning behind the imposition of unlimited tax liability to the residents of a jurisdiction, is that they benefit from the organization and infrastructure of that country to develop their respective economic activities.

- **Source principle:** Under the source principle a country is entitled to levy taxation on the income that is generated within its territory, regardless of the residence of the taxpayer.

Due to avoidance of double taxation, countries in their domestic laws can adopt unilateral measures, such as foreign tax credits recognizing the taxes paid abroad. Nevertheless, the tax treaty system has introduced tax attribution rules for income generated in one jurisdiction by residents of another treaty state, and had designed a set of rules to distribute the taxing rights between the contracting states. So, it is through

⁹ Ibid at 19&20.

¹⁰ Van Weeghel S. The Improper Use of Tax Treaties, *Kluwer Law International*, 33(1998).

the instrument of attribution of taxing rights that the tax treaties propose to solve the issues of double taxation and the conflict between the residence principle and the source principle.

The tax treaty system allows contracting states to choose either a credit system or exemption system to avoid double taxation. Also it is important to point out that the tax treaty regime recognizes the different income categories that are adopted under domestic tax law. As a general rule, the residence state have taxing rights over income generated from movable and intangible property, and portfolio investment income. On the other hand, the source state has jurisdiction to tax business income as long as that income is attributable to the activities of a permanent establishment in that state. Therefore, source principle taxation under the tax treaty system is triggered if a strong economic connection exists between the entity and the source contracting state, in such case the residence country could have residual taxing rights and must provide tax relief to prevent double taxation.

One can argue that one of the objectives to design structures creating tax residence in one jurisdiction to access tax treaty benefits, is to reduce or prevent the withholding taxes levied in the source country on payments of passive income such as interest, royalties and dividends to residents of the other contracting state. The withholding rates on source income are the result of negotiations between contracting states, meaning that withholding rates vary from one treaty to another, also depending on the categories of the income. The tax treaty system have three main objectives. They are the Avoidance of the Double taxation, Prevention of Tax Avoidance and Tax Evasion and Non Discrimination.

2.3.AVOIDANCE OF DOUBLE TAXATION

The main objective of tax treaties the avoidance of double taxation. To do this, the contracting states agreed in the design of common definitions within the text of the treaty to assign fully or partly the right to tax to one of the countries involved, leaving to the other state residual rights. This objective is achieved by granting tax relief either by the credit system or the exemptionsystem.According to Professor Van Weeghel, the OECD tax treaty convention assumes that “an item of income will be taxed in at least one of the contracting states”¹¹. According to this point of view, the whole idea behind the system is that the contracting states will agree on a method (exemption system or credit system), that allows the taxation of an item of income fully one time, always having in mind that by entering into a tax treaty the contracting states do not renounce to the right to tax, simply the treaty system assign the right to tax to one of the parts involved, which means that the domestic law will apply to the item of income, but the contracting states will choose the method to avoid the double taxation.

¹¹ Supra note no:10, at 33.

2.4.PREVENTION OF TAX AVOIDANCE AND TAX EVASION

This study will focus on the effectiveness of the instruments adopted to counter tax treaty abuse, such as LOB provisions and the PPT, which are mechanisms in line with the prevention of tax avoidance and evasion as an objective of the treaty system.

The OECD Model Convention does not explicitly refer to tax avoidance as an objective of the treaty system, but with the BEPS discussion, particularly Action 6 it is recommended to amend the title and preamble of the Model Convention to include such objective. This is not the case of the US Model Convention, which expressly states the prevention of fiscal evasion as a main purpose.

Tax avoidance and evasion objective has been present in the discussions and several amendments of the OECD Model Convention, but is probably addressed in a better manner in the commentaries to the Model Convention.

Both the academia and the governments that are part of the OECD and those that are not in this group are engaged in the development of the measures to tackle tax avoidance, tax evasion and the improper use of treaties, which are terms that have unique definitions and also different consequences in the practice of international taxation law. Tax evasion refers to the taxpayer behavior who knowingly intends to avoid the payment of taxes to a tax administration, it is clearly a case of a crime against the public administration; tax avoidance is not a crime in itself since it comes to the design of structures to circumvent or minimize taxation charges, but still can be within the scope of legitimate tax planning, design as a response to commercial or business reasons.

In the case of the improper use tax treaties, the researcher intends to follow the statement of professor Vogel regarding the qualification of such concept, as a form of tax avoidance.

2.5.PRINCIPLE OF NON DISCRIMINATION¹²

Another objective of tax treaties, at least in the OECD Model Conventions is to prevent discrimination of nationals of the contracting states. The provisions contained in the OECD Model Convention are related to non-discriminatory taxation in respect of permanent establishments, deductibility of royalty and interest payments, and prevention of nondiscriminatory treatment to non-resident-controlled enterprises.

The non-discrimination provisions prevent the imposition of a larger or smaller tax burden on income attributable to a non-resident. But it is also important to note that these measures must ensure that treaty-based withholding tax measures are applied equally by the parties involved.

2.6. TAX TREATY CONVENTIONS

When countries decide to enter into a tax treaty, one of the main points in the negotiation process is to determine to what extent, the source state will agree on limiting or renouncing its taxing rights.

¹² Supra notes no: 8 at 21.

If the source state agrees on restricting its taxing rights, the residence state will fully tax the profits of its resident, whereas if the source state does not agree to the restriction of the taxing rights, the residence state shall either grant an exemption or a credit for taxes paid in the source state, in order to avoid double taxation.

There are two main models often used by the countries as a starting point to negotiate their double tax conventions, the OECD Model Convention and the UN Model Convention.

The two Model Conventions differ from one another in the way they apply the source base taxation, taking into consideration the aim of the each organization and the status of its members. The OECD is an international organization, and its members are industrialized countries, which have the same economic standards. On the other hand, the UN Model is explicitly directed to provide guidance to developing countries

2.6.1.OECD Model Convention

The OECD Model contains seven chapters. Chapters I and II outline the scope of the Convention, establishing the requirements for the application of the tax treaty and introducing the definitions to the terms of the treaty. Chapters III and IV contain the distributive rules of the tax treaty for each item of income. Chapter V provides the tax relief methods (exemption and credit systems). Chapter VI contains a series of administrative provisions such as the Mutual Agreement Procedure (MAP), also contains the non-discrimination clause. Chapter VII establishes the entry into force and the termination clause of the treaty. Finally, the treaty also consists of the protocols annexed to a treaty which are part of the treaty and have binding force. The OECD Model is primarily intended to grant taxing rights to the resident state, and very few items of income are assigned to the source state. For instance, the residence state has the right to tax dividends and interest. If the source state also tax these items of income, the withholding tax shall not exceed certain rates.

As a general rule, in the OECD Model the source state may tax the business profits derived from activities within the source state (through a Permanent Establishment). The residence state then is not allowed to tax those profits under the tax treaty, but the resident state would tax the profits in accordance with its domestic legislation.

2.6.2.UN Model Convention

As stated before, the needs of developing countries are taken into account by the UN Model Convention. The United Nations in the 1960s set up a group of experts to design a Model Convention with guidelines for the developing countries, creating a proposal in which primarily the taxing rights belong to the state of source. Nonetheless, it is important to say that the UN Model followed the OECD Model with few differences in its structure.

Under the UN Model the taxing rights are granted to the source state. The rationale behind this is that the source state in the UN Model is usually a developing country, so they can tax a larger portion of the income derived in their jurisdiction.

CHAPTER – 3

TREATY SHOPPING

To be eligible for the benefits of the DTAA between two nations, a person must be a resident of one of the countries. Treaty Shopping occurs when a resident of a third nation takes advantage of a DTAA between two countries. The resident of a third nation obtains the residency of a country in order to profit from the DTAA of that country with the other country, similar to shopping.

It was claimed in *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA*(2006)¹³ that "Treaty Shopping is an inappropriate use of the tax treaty since it is opposed to the purposes of the treaty's formation." Treaty shopping occurs when non-resident taxpayers seek to benefit from a tax treaty by forming a business or other legal entity in one of the Contracting States to serve as a conduit for income generated in the other Contracting States."In re(2010), the Authority for Advance Ruling in *E-Trade Mauritius Ltd.*¹⁴ defined the term as follows: "Treaty Shopping broadly denotes the use of a treaty by a person who is not a resident of either of the treaty nations, frequently through the use of a conduit business based in one of the countries."

3.1. HISTORY AND FEATURES OF THE TREATY SHOPPING METHOD

While the globalisation process has been developing for thousands of years, more behaviour that may be considered "treaty shopping" has emerged. It has been increasingly popular among businesses, and numerous examples of its practical use can be found particularly since the 1980s of the twentieth century, when scholarly views on how to avoid "treaty shopping" emerged. The "treaty shopping" approach may be characterised as a type of tax evasion that is generally carried out by three or more corporate organisations.

However, just two of them (assuming there are three "tax shoppers") or none of them (assuming there are more than three "tax shoppers") require a formal contractual relationship. However, because they are not opposed to paying high taxes, they will adopt another company organisation to appear in their contractual relationship (often in an agreement) in order to pay a lower tax rate or even none at all.

Table 1 shows an example of the "treaty shopping" approach in action.

	Company A	Company B	Company C
Company A	-	15%	2%
Company B	15%	-	5%
Company C	2%	5%	-

Company A intends to send dividends to Company B, for example, and the transaction is taxed at a 15% tax rate under the agreement on the avoidance of double taxation between countries A and B. However, the transaction is taxable at a 2% tax rate under the agreement on the avoidance of double taxation between

¹³ *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA*(2006) EWCA Civ.158.

¹⁴ *E-Trade Mauritius Ltd. In re*(2010)190 Taxmann 232 (AAR).

country A and country C, and at a 5% tax rate under the convention on the avoidance of double taxation between country C and B.

The results of employing the "treaty shopping" technique are shown in Table 2.

	Company A	Company B	Company A + Company B
Company C	2%	5%	7% (2%+5%)

As a result, corporate entities are adopting "treaty shopping" tactics and becoming "treaty shoppers" while deciding for firm C to be engaged in the transaction between A and B only to pay a 7 percent tax rate (2 percent + 5 percent). The growth of globalisation was the major cause for the "treaty shopping" method's rising popularity.

The word "globalisation" refers not just to the territory including European countries and the United States of America, but also to tiny islands frequented by "treaty shoppers" looking to reduce their tax burden.

"Tax heavens," according to scholarly opinion, are areas where the tax rate is extremely. Business entities typically drive their growth by relocating their operations there in order to pay a lower tax rate or avoid paying any taxes at all. The number of "tax heavens" now ranges from 35 to 50. The Bahamas, Bermuda, the Cook Islands, the Seychelles, the Cayman Islands, and many others are among the most popular "tax havens". To exploiting "tax heaven" is when a corporate organisation takes practical use of the low tax rate by basing its place of residence in "tax heaven" under the convention on the avoidance of double taxation and, as a result, pays a lower tax rate than the tax rate in their home country.

Let the above instances enough to demonstrate that there are an increasing number of difficulties associated with the use of "tax heavens." Not unexpectedly, the "tax technique" is usually predicated on the advantages provided by low tax rates in "tax heaven."

The fact that corporate organisations appear to have a notable inclination to include "tax heavens" such as The Bahamas, Bermuda, The Cook Islands, The Seychelles, The Cayman Islands, or similar in their transactions to pay reduced tax rates is an excellent illustration of the problem described above. That behaviour became popular in the second part of the twentieth century for two major reasons, one of which was that the "treaty shopping" approach was only beginning to gain popularity in the 1960s, and few people were aware of the implications. As a result, the preventative outlooks and mechanisms have yet to be established. That also implies that certain areas previously regarded as "tax havens" have no longer been such.

However, instances in which businesses employ both the "treaty shopping" approach and the "tax heavens" method are not uncommon. There appear to be a number of large businesses (legal persons, partnerships, publicly traded corporations, and share-holding companies) and even sole proprietors who make practical use of the link between the aforementioned illegal behaviour and tax-free jurisdictions. The method is straightforward and based on the model described above: when dividends sent from business A to company

B are taxed at a 10% rate under the agreement between nation A and country B, firms A and B elect to incorporate company C (from "tax paradise") in their contractual relationship. Companies A and B pay a lower tax rate or even avoid paying taxes as a result of the introduction of business C. It is critical to stress that it may commonly have a greater negative influence on each country's legal system due to the fact that corporate organisations are breaching not one, but two norms of law.

Table 3: A chance to take advantage of the "treaty shopping approach" and "tax heavens."

	Company A	Company B	Company C (Tax heaven)
Company A	-	15%	1%
Company B	15%	-	2%
Company C (tax heaven)	1%	2%	-

Company A intends to send dividends to Company B, for example, and the transaction is taxed at a 15% tax rate under the agreement on the avoidance of double taxation between countries A and B. However, the transaction is taxable at a 1% tax rate under the agreement on the avoidance of double taxation between country A and country C (tax heaven), and at a 2% tax rate under the convention on the avoidance of double taxation between country C and B.

The implications of adopting the "treaty shopping technique" and "tax heavens" are shown in

Table 4.

	Company A	Company B	Company A + Company B
Company C (tax heaven)	1%	2%	3% (1% + 2%)

As a result, corporate entities are adopting "treaty shopping" tactics and becoming "treaty shoppers" while deciding for company C (tax heaven) to be engaged in the transaction between A and B only to pay a 3 percent tax rate (1 percent + 2 percent).

Table 5: A chance to take advantage of the "treaty shopping approach" and "tax heavens."

	Company A	Company B	Company C (tax heaven)
Company A	-	15%	1%
Company B	15%	-	0%
Company C (tax heaven)	1%	0%	-

Company A intends to send dividends to Company B, for example, and the transaction is taxed at a 15% tax rate under the agreement on the avoidance of double taxation between countries A and B. However, the transaction is taxable at a 1% tax rate under the agreement on the avoidance of double taxation between country A and country C (tax heaven), and at a 0% tax rate under the convention on the avoidance of double taxation between country C and B.

The implications of adopting the "treaty shopping technique" and "tax heavens" are shown in Table 6.

	Company A	Company B	Company A + Company B
Company C (tax heaven)	1%	0%	1% (1%+0%)

As a result, corporate entities are adopting "treaty shopping" tactics and becoming "treaty shoppers" while deciding for company C (tax heaven) to be engaged in the transaction between A and B only to pay a 1 percent tax rate (1 percent + 0 percent).

Table 7: The "treaty shopping technique" and "tax heavens" can be used.

	Company A	Company B	Company C (tax heaven)
Company A	-	15%	0%
Company B	15%	-	0%
Company C (tax heaven)	0%	0%	-

Company A intends to send dividends to Company B, for example, and the transaction is taxed at a 15% tax rate under the agreement on the avoidance of double taxation between countries A and B. However, the transaction is taxable at a 0% tax rate under the agreement on the avoidance of double taxation between country A and country C (tax heaven), and at a 0% tax rate under the convention on the avoidance of double taxation between country C and B.

The implications of adopting the "treaty shopping technique" and "tax heavens" are shown in Table 8.

	Company A	Company B	Company A + Company B
Company C (tax heaven)	0%	0%	0% + 0%

As a result, corporate entities are adopting "treaty shopping" tactics and becoming "treaty shoppers" while deciding for company C(tax heaven) to be engaged in the transaction between A and B only to pay a Nil tax rate (0 percent + 0 percent).

3.2. OBJECTIVES OF TREATY SHOPPING

The device of treaty shopping is used to obtain the tax advantage. It is achieved because the third country has the treaty with the first which the said another country does not have or because the route is more beneficial than the direct route even though there is an appropriate tax treaty on that route also. Resident of third country obtain the resident certificate of that particular country which according to their DTAA with other country in which resident of third country intended to make investment imposes low or no withholding tax on royalties, interest, dividends or capital gains etc. By using the device of treaty shopping help the resident of third country to established in a jurisdiction which has a wide treaty network with other countries. The Switzerland and Holland which have favourable treaty network with other countries, therefore most of the multinational corporations commonly use them as a base for international investments.

3.3. EFFECTS OF TREATY SHOPPING

While entering into DTAA the countries are free to determine its structure, terms and conditions rate of withholding tax on different kinds of income, generally the structure of DTAA depends upon the economic and political relationship . The device of treaty shopping affects the source country by loss of revenue by restricting the rate of its withholding tax in comparison the rate of tax they have to pay as per the DTAA with their country. The tools of treaty shopping assisting tax avoidance to the residents of third country, which a treaty intends to prevent.

3.4.IN INDIA, JUDICIAL INTERPRETATION OF TAX LEGISLATION AND TREATY SHOPPING

In the case of *IRC v. Duke of Westminster* (1936)¹⁵, a British court read the tax legislation literally for the first time. It was decided that a tax legislation should be interpreted strictly or literally. An arrangement is evaluated based on its legal form rather than its economic or commercial content, and an arrangement is functional for tax reasons even if it has no business purpose and was entered into to avoid paying taxes. The Westminster theory allowed tax payers to arrange their tax planning inside the four corners of the law in order to avoid paying the tax. In the case of *W.T. Ramsay v. IRC*(981)¹⁶, the British court deviated from the Westminster approach by establishing the doctrine of "fiscal nullity."¹⁷ It indicates that in order to avoid the tax, an agreement must be evaluated based on its economic or commercial substance rather than its legal structure.

¹⁵ RC v. Duke of Westminster (1936) A.C.1.

¹⁶ . W.T. Ramsay v. IRC(981) 1All ER 865.

¹⁷ Ibid

In the case of *CIT v. A. Raman & Co.* (1968)¹⁸, it was established that every tax payer has the right to structure his affairs such that the tax attaching under the legislation might be avoided. In other words, the taxpayer may organise his affairs in accordance with the rules of the legislation in order to avoid the tax, and the revenue authorities may not take any action against the taxpayer on the grounds that it lacks economic or commercial substance. In the decision of *McDowell & Co. Ltd. v. CTO* (1985)¹⁹, the Supreme Court stated, "we believe the moment has come for us to diverge from the Westminster concept as forcefully as the British courts have done."²⁰ Because the border between tax evasion and tax avoidance is so thin, it is necessary to prioritise content over form when calculating tax responsibility under the legislation.

The Government of India has reached an agreement with the Government of Mauritius to minimise double taxation and to prevent fiscal evasion. It applies to anyone who live in either of the contracting countries, India or Mauritius. It further said that capital gains arising from the transfer of shares to a Mauritius person will be taxed in accordance with Mauritius legislation. Capital gains arising from the transfer of shares are tax-free in Mauritius. Instead of investing directly in India, the majority of Foreign Institutional Investors (FIIs) used the Mauritius window to do so. Foreign institutional investors created a conduit firm in Mauritius without doing any business or commercial activity in Mauritius, and then invested in India via them. The effects are that FIIs would benefit from the DTAA between India and Mauritius since they would not be required to pay tax on capital gains arising from the transfer of shares in India. "CBDT clarified that whenever a certificate of residence is issued by the Mauritius authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the agreement accordingly"²¹ and also, for the purpose of capital gains on the sale of shares, FIIs resident in Mauritius would not be taxed in India on income from capital gains. The offshore firms registered in Mauritius for the purpose of not doing business in Mauritius are known as FIIs.

In the case of *Shivkant Jha v. Union of India* (2002)²², the Delhi High Court held that the Income Tax Officer is entitled to raise the corporate veil in order to determine whether a company is a resident of Mauritius or not, and to refuse the benefit of the agreement if found not to be so on the basis of the treaty shopping doctrine. The court also ruled that treaty shopping is prohibited. Delhi High Court departed from the Westminster principle and followed the Ramsay principle.

However, in the case of *Union of India v. Azadi Bachao Andolan* (2003), the Supreme Court of India disagreed with the decision of the Delhi High Court and stated that: "There are no disabling or disentitling conditions under the convention prohibiting the resident of a third nation from deriving benefits there under."²³ The motivations for why inhabitants of a third nation have been incorporated in Mauritius are completely immaterial and have no bearing on the transaction's validity. The principle of breaching the

¹⁸ CIT v. A. Raman & Co. (1968) 67 ITR 115C.

¹⁹ McDowell & Co. Ltd. v. CTO (1985) 154 ITR 148 SC.

²⁰ ibid

²¹ cbd, its, circular, number 789, 13th, april, 2000 available at <http://www.legalservicesindia.com/article/1195/The-Double-Tax-Avoidance-Agreement-between-India-and-Mauritius.html>.

²² Shivkant Jha v. Union of India (2002) 122 Taxmann 952.

²³ Union of India v. Azadi Bachao Andolan (2003) 132 Taxmann 373.

corporate veil cannot be used. The only solution is to make a change to the DTAA between India and Mauritius to ban treaty shopping. The Supreme Court of India once again adhered to the Westminster concept, which was categorically rejected by the British Court, as opposed to the "fiscal nullity" approach advanced by the court in the Ramsay case. Many governments accept treaty shopping, even if it is illegal and results in large revenue loss, since it is viewed as a tax advantage to entice foreign investment in the country.

On May 10, 2016, both India and Mauritius signed a Protocol to modify the Convention to avoid double taxation and to combat fiscal evasion with respect to taxes on income and capital gains. Following the completion of internal procedures in both countries, the Protocol entered into force in India on July 19, 2016 and was published in the Official Gazette on August 11, 2016. With effect from the 2017-18 fiscal year, the Protocol allows for source-based taxation on capital gains deriving from the alienation of shares purchased on or after April 1, 2017 in a business domiciled in India. Concurrently, investments made prior to April 1st, 2017 have been grandfathered and will not be subject to capital gains taxation in India. Where such capital gains emerge during the transition period from April 1, 2017 to March 31, 2019, the tax rate will be restricted to 50% of India's domestic tax rate.

Taxation at the full domestic tax rate will begin in India in the fiscal year 2019-20. The advantage of a 50% reduction in tax rate during the transition period is subject to the Limitation of Benefits Article, which states that a Mauritius resident (including a conduit business) will not be entitled to the benefit of a 50% reduction in tax rate if it fails the principal purpose test and Bonafide business test. A resident is considered a conduit company if its total expenditure on activities in Mauritius in the preceding 12 months is less than Rs. 27,00,000 (Mauritian Rupees 15,00,000). The Protocol also includes provisions for source-based taxation on interest income, wherein interest earned in India and sent to Mauritian resident banks would be subject to withholding tax in India at the rate of 10%. the rate of 7.5 percent for debt claims or loans issued after March 31, 2017.

However, interest income of Mauritian resident banks in respect of debt-claims existing on or before March 31, 2017 will be free from tax in India under the Convention's existing provisions. The Protocol also includes provisions for amending the Exchange of Information Article to reflect worldwide standards, as well as provisions for tax collection assistance and source-based taxation on other income, among other adjustments. The Protocol would address treaty abuse and round tripping of money ascribed to the India Mauritius Treaty, as well as reduce revenue loss, eliminate duplicate non-taxation, streamline investment flows, and increase information sharing between the two Contracting Parties. It will increase openness in tax proceedings and assist to reduce tax evasion and avoidance.

3.5. ADVANTAGES

The Supreme Court noted in *Union of India v. Azadi Bachao Andolan* that treaty shopping was frequently used in poor nations as a tax inducement to attract limited foreign capital or technology. Foreign investment is very important to developing countries. Treating yourself to a shopping trip may be a powerful motivator to make such expenditures. In order to accommodate inflows of money and technology from rich

nations, developing governments may allow treaty shopping. The tax losses incurred as a result of treaty shopping may be considered a minor expense in comparison to the large profits obtained via economic activity and related advantages flowing to the country as a result of such investments. Typically, such source nations maintain a "closed eye" attitude against treaty shopping unless and until revenue losses result in a major erosion of total revenues/benefits to the state, or such actions result in other legal violations. Treaty shopping may be accepted as a cost of long-term growth by developing countries; in this case, the increased economic activity from treaty shopping might more than balance the country's tax losses.

3.6. DISADVANTAGES

Both the OECD and the UN consider treaty shopping to be detrimental. If the data are looked at, the income lost due to treaty shopping is significantly high. Because the "tax authorities anticipated a revenue loss of over Rs.5,000 crore due to treaty shopping, India's tax treaty with Mauritius was examined"²⁴.

3.6.1. Treaty Shopping violates a tax treaty's reciprocity

First and foremost, it is argued that treaty shopping is a means of tax evasion, and so goes against the goals of tax treaties. Treaty shopping, it is also claimed, violates a treaty's reciprocity and results in income loss by breaching the concept of reciprocity. Treaty shopping results in disproportionate benefits for the state of residency relative to the source state. By using treaty shopping, a person whose country has not entered into an agreement with the source country (which is the investment destination and source of income) and thus is unable to reciprocate similar benefits (including information exchange), can derive the benefits of the source country's treaty with a third country. The treaty's intended quid pro quo is obviated in this process, and the intended profit is hijacked.

3.6.2. Third-country income increases as a result of treaty shopping

Second, a taxable base is traceable to the jurisdiction where it is considered to have its economic existence, according to the concept of economic loyalty. In terms of the allocation of taxation rights between countries, tax treaties are based on this premise. Treaty concessions are solely intended to be available to inhabitants of treaty nations, with no plans to extend them to citizens of other countries. It's possible that a third country may profit from treaty shopping even if there's no claim to economic allegiance. It may also be claimed that treaty shopping discourages nations from enacting tax treaties because the benefits of such treaties mostly favour third countries, resulting in a loss for countries that have a right under the economic

²⁴ Manju Menon, India asks Mauritius to review tax treaty, The Times of India, Jan 19, 2007, available at <https://timesofindia.indiatimes.com/business/india-business/india-asks-mauritius-to-review-tax-treaty/articleshow/1322646.cms> (assessed on 9 November 2021).

loyalty principle. It might also put nations who have committed to fiscal cooperation and information sharing at a competitive disadvantage in the global financial market.

3.6.3. Treaty Shopping Causes Revenue Loss

Finally, it's possible that treaty shopping is associated with unfavourable revenue loss. Tax treaties are based on a balanced analysis of capital and income flows between the nations involved. When this equilibrium is disrupted as a result of treaty shopping, the income between these nations is inevitably distorted. Treaty shopping causes the bilateral connection of the treaty to be stretched to encompass transactions and situations that are not covered by the underlying intent, resulting in the bilateral character of the treaty being de facto transformed to multilateralism. This might result in the originating country incurring large unjustified costs.

CHAPTER - 4

MECHANISMS FOR PREVENTION OF TREATY SHOPPING

Countries are engaged in an effort to design anti-abuse rules to prevent the avoidance of taxation mainly, and specifically the design of rules to prevent the circumvention of the residence principle in order to obtain treaty benefits that are not supposed to be granted to taxpayers that are not residents of the contracting states. In this chapter, scholar will analyze the rules designed by the tax treaty regime in order to prevent treaty shopping. The mechanisms that will be presented are the Beneficial Ownership concept, the Limitation on Benefits Provisions and the Principal Purpose Test .

4.1.THE BENEFICIAL OWNERSHIP CONCEPT

The vast majority of countries base their taxation systems on the residence and source principles, which could lead to double taxation issues when it comes to international transactions. Countries may avoid this problem either unilaterally adopting legislation that relieves certain items of income from tax or bilaterally by entering into tax conventions.

One of the main objectives of the Tax Treaty system is to prevent double taxation of the tax residents of the contracting states, by mutually agreeing to restrict their taxing rights under domestic tax laws. As a consequence of the application of tax relief in accordance with the tax treaty provisions, usually the contracting states agreed on partially, or fully, exempt passive income from withholding tax levied by the source country.

The idea behind the tax treaty system is that the benefits should only be granted to the residents of the contracting states, never to third parties, and that there must be a strong economic connection of the residents with the countries involved in a tax treaty. However, residents of third countries interpose the so called conduit companies in one of the contracting states in order to obtain tax benefits.

To analyze the OECD Model Convention approach to prevent a third country resident to access treaty benefits, contained in “Articles 10, 11 and 12 of the Model Convention”²⁵. In a broad sense, these provisions allow the reduction of withholding taxes levied by the source state on passive incomes such as dividends, interests and royalties that flows from the source state to a resident of the other contracting state. In order to achieve that goal, the OECD Model Convention requires the recipient of the income to be the beneficial owner of the income.

The term “beneficial ownership” is not defined within the Model Convention, which represents a difficulty to interpret and apply the concept. The beneficial ownership is a test that uses an economic substance approach to determine whether the recipient of a revenue is the true owner of the income and not a resident of a third country.

The OECD first Model Convention was presented on 1963, but the term “beneficial ownership” was introduced until the OECD Model Convention of 1977. As mentioned before, the term was included in the articles 10, 11 and 12 that deal with dividends, interests and royalties respectively, these provisions address the reduction of withholding taxes by the source state, and the term beneficial owner was introduced as a test to determine if a subject is entitled to treaty protection.

According to the commentaries on articles 10, 11, and 12 of the OECD Model Convention 1977, the purpose of the introduction of the concept was to clarify the meaning of the words —paid....to a resident of a contracting state in Articles 10(1), 11(1) and 12(1)

Article 10

1. Dividend 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 recipient is the beneficial owner of the dividend the tax so charged²⁶

Article 11

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 interests may also be taxed in the Contracting State of which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged²⁷.

²⁵ Supra note no: 8

²⁶ Supra note:8 at 10.

²⁷ Supra note:8 at 11.

Article 12

Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties²⁸.

The commentary on articles 10, 11 and 12 makes it clear that the source State is not obliged to render its taxing rights just by the fact that the receiver of the income is a resident of the other Contracting State. The statement is that the recipient of the income must be the beneficial owner of the income.

4.1.1 Interpretation of the term Beneficial Ownership

Applying the beneficial ownership test to interposed companies from an economic perspective seeks to prevent treaty benefits being passed on to residents of non-contracting states. According to this approach, treaty benefits on passive income can only be granted to residents of the contracting states that are ultimately the recipients of the economic benefits, irrespective of who is the immediate recipient of the income.

Articles 10, 11 and 12 of the OECD Model Convention apply the term beneficial owner as a provision to prevent the design of tax planning to allow residents of a third state incorporate a conduit company in a contracting state to obtain a withholding tax reduction. Scholar will now refer to the use of conduit companies to invoke treaty protection.

4.1.2. Conduit companies

A conduit company is a company incorporated in the resident state, that stands between a company located in the source state that pays passive income (dividends, interests or royalties) to a company incorporated in the other contracting state, and a company located in another noncontracting which seeks to obtain the benefits of the tax treaty between the source state and the resident state.

Example for conduit company. Company A that is resident in State R derives passive income (dividends, interest or royalties) in a company resident in State S (source state). In this case there is no tax treaty between State R and State S, so State S levies withholding taxes on the flow of income to the resident state. However, there is a tax treaty between State S and State X, which reduces the withholding taxes on the passive income paid by residents of State S to residents in State X, where the foreign source passive income is tax exempt.

4.1.3. Example for direct conduit companies

In order to eliminate the withholding tax to passive income flowing from State S to State R, the company in State R incorporates a wholly owned subsidiary in State X and transfers ownership of all the assets and rights held on the State S (the company incorporated in State X has no economic substance). We can assume that as a legal owner of the passive income derived from State S, the State X company can claim relief from the withholding in State S, and then based on a contracting obligation, passes on the income to State R. For the purposes of the example, we can assume that the company incorporated in State X is a conduit

²⁸ Supra note:8 at 13.

company incorporated with the sole purpose of obtaining the benefits from the tax treaty between State R and State S, structure that has been called by the OECD as the direct Conduit tax planning scheme.

4.2. LIMITATION ON BENEFITS

Researcher will provide an overview of the approach proposed by the OECD in BEPS Action 6. Specifically, on the LOB.

Anti-avoidance rules are a tool used to counter the abusive conduct of taxpayers in order to eliminate or reduce tax charges on international transactions. Often, taxpayers structure their businesses or transactions in such a way result with as little tax as possible. However, when the only or the primary reason for choosing the structure is tax motivated it should be considered to be an abusive behavior, and those circumstances must be prevented by the countries engaged in tax treaties through the use of anti-avoidance rules.

4.2.1. The Limitation on Benefit provision according to BEPS ACTION 6

In 2013, the OECD started to work on the issue of profit shifting and base erosion. The main purpose of the project is to establish effective ways to ensure that profits are taxed in the jurisdiction where the economic activities are performed and where the value is created. According to the OECD, the project is a result of the growing necessity to tackle aggressive tax planning aimed to circumvent the compliance of tax regulations in order to obtain benefits through the improper use of tax treaties or taking advantage of mismatches between domestic tax law systems.

One of the main purposes of the BEPS project is to prevent treaty abuse, in particular treaty shopping, which is addressed by Action 6. The BEPS Action 6 is dedicated to Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, as the OECD considers tax treaty abuse as one of the most important sources of BEPS concerns.

In September 2014, the OECD published the comments by Member States to the draft report with the recommendations on this matter. After the discussions, the final draft of BEPS Action 6 was published October 2015, the report contains three areas to work on, in order to counter treaty abuse:

- a. The design of treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances;
- b. A clarification that the treaties are not intended to be used to generate double non taxation;
- c. Identifying the tax policy considerations that countries should consider before engaging in tax treaties.

The implementation of the proposals included in BEPS Action 6 will take place in form of changes in the OECD Model Convention.

To analyzing the objective of preventing treaty abuse as an objective of BEPS Action 6. To prevent the use of treaties in inappropriate circumstances BEPS Action 6 presents two types of cases:

1. Cases where a person circumvents provisions of the treaty itself, and;
2. Cases where a person circumvents the provisions of domestic tax using treaty benefits.

As a general rule, to have access to treaty benefits the main requirement is to be resident of one of the contracting states. The residency condition requires the taxpayer to be liable to tax in the corresponding contracting state. Therefore, treaty shopping in its most basic form consists in the circumvention of the resident requirement, by the use of conduit companies by noncontracting parties to obtain treaty protection. The approach of the OECD to prevent treaty abuse is the inclusion of specific provisions in the tax treaties. According to the BEPS Report, three action are recommended in order to attack treaty abuse:

- a) Amendment of the title and preamble of the OECD Model Convention in order to clearly state the purpose of the tax treaties is not intended to generate opportunities for treaty abuse.
- b) Incorporation of a LOB.
- c) Incorporation of the PPT as a GAAR, to address those situations of treaty shopping that the LOB would not cover.

The OECD recommendation consists of the inclusion of a specific anti-abuse rule as the Limitation on Benefits to prevent granting treaty benefits in abusive situations, by establishing various requirements and thresholds to be entitled to treaty benefits. Under the current OECD Model Convention, the taxpayers in order to have access to the treaty benefits have to fulfil the conditions set forth in articles 1, 3 and 4 of a Model Convention. The idea of the LOB provision is that meeting the requirements of articles 1, 3 and 4 is no longer enough. The proposal is that in order to have treaty protection a taxpayer must be regarded as a “qualified person” by meeting the requirements of the LOB provision, basically because the OECD considers that the requirements on the current articles are easy to circumvent.

Paragraph 1 of the proposed LOB provision establishes that in order to have access to treaty benefits, a resident of a contracting state must be a “qualified person”. Paragraph 2 of the proposed LOB article included in the BEPS Report, sets out the definition of “qualified persons” who automatically have access to treaty benefits.

2. Definition of situations where a resident would be a qualified person, which would cover
 - a) an individual
 - b) contracting states or its political subdivisions and entities that it wholly owns;
 - c) certain publicly-listed entities and their affiliates (stock exchange test)

- d) certain charities and pension funds
- e) other entities that meet certain ownership requirements (ownership and base erosion test)
- f) certain collective investment vehicle

In particular, in the case of the requirements of subparagraphs c) and e) contains two tests (i) the stock exchange test, and (ii) the ownership and base erosion test, which a person must fulfil in order to be a qualified person, which I will explain in a specific section below.

However, if a resident does not meet the above requirements, he can still have access to treaty benefits, if he fulfils the requirements of paragraphs 3, 4 or 5 of the LOB provision.

Paragraph 3, contains the activity test, with respect to a specific item of income. According to this test, the resident has to be engaged in the active conduct of a business in the residence state.

Paragraph 4, is the so called “derivative benefits clause”, that allows to certain entities owned by residents of other states to obtain treaty benefits which they would have obtained also if they had invested directly.

And, Paragraph 5, contains a discretionary relief clause, giving the possibility to grant treaty benefits to non-qualified residents on request of a taxpayer. According to this rule, the tax authority may grant benefits to taxpayers under discretion, to those who fail the tests, but should be granted treaty benefits as the taxpayer did not have as one of their principal purposes the obtaining of treaty benefits.

In general, a corporation or a company, would be considered to be a qualified person and therefore eligible for treaty benefits if it meets the following objective tests: (i) publicly traded test; (ii) the ownership test and the base erosion test; (iii) active business test; (iv) derivative business test, together with the base erosion test; and, (v) corporations that nevertheless do not fall within the scope of the “qualified person” concept, but which are considered to be bona fide by tax authorities under the discretionary relief clause (paragraph 5)

Because of these tests, the LOB provision is highly complex, and can be difficult to apply for some countries tax authorities, but offers legal certainty in granting treaty protection. As the OECD admits in the Report: “The administrative capacity of some countries might prevent them from applying certain detailed treaty rules and might require them to opt for more general anti-abuse provisions”²⁹

The LOB provision is so complex, due to the fact that under this approach the OECD do not rely on the intention or purpose of the taxpayers, thus including a set of objective rules. These objective requirements are very technical and complicated to administer, such as the ownership test, but as said, gives certainty to taxpayers to determine whether or not they have access to the treaty benefits.

²⁹ OECD Report,17,available at

https://www.academia.edu/26201748/OECD_G20_Base_Erosion_and_Profit_Shifting_Project_Preventing_the_Granteeing_of_Treaty_Benefits_in_Inappropriate_Circumstances_ACTION_6_2015_Final_Report

In the following sections scholar will address the tests included in BEPS Action 6 provision in more detail:

4.2.2. The publicly traded company test

The publicly traded company test is contained in paragraph 2(c) of the LOB article in the BEPS Action 6 report. The rationale of this test is that the shares of a publicly traded company are as a general rule subject to strict legislation, and companies listed on a stock exchange usually have a strong connection with the state of incorporation, which gives to the OECD sufficient reason to conclude that these companies are unlikely to be conduit companies incorporated only for treaty shopping reasons.

According to this test, a company or other entity can be considered as a qualified person if:

(i) The principal class of its shares (and any disproportionate class of shares) is regularly and primarily traded on one or more recognized stock exchanges located in the contracting state in which the company is resident;

(ii) The principal class of its shares is regularly traded on any recognized stock exchange and at the same time, the company's or entity's primary place of management and control is in its resident contracting state; or

(iii) At least 50% of the company's or entity's shares are owned, directly or indirectly by five or fewer publicly traded companies that satisfy either requirements (i) and (ii) .

As mentioned, the reason of this test is that publicly traded companies are unlikely to be conduit companies incorporated only for treaty shopping reasons, because these kind of companies are subject to severe rules, but also serves to tax authorities as an effective tool to monitor these companies.

4.2.3. The ownership test and the base erosion test

The ownership test and the base erosion test are contained in the paragraph 2(e) of the proposed LOB article, and it comprises two cumulative tests that need to be complied with. The two tests ensure that a majority of the equity (the ownership test) and non-equity (the base erosion test) are owned by residents of the contracting states.

4.2.3.1. The ownership test

The ownership test requires that at least 50% of the voting power and value of the company's shares must be owned, directly or indirectly, by 'qualified persons'.

4.2.3.2. The base erosion test

The base erosion test is satisfied when less than 50% of the company's gross income for the taxable period, is paid to persons who are not qualified residents of either contracting state in the form of deductible payments.

This test requires a sufficient percentage of local ownership and the absence of significant base erosion, in other words, the taxpayer must have a real nexus in the contracting state.

It is very important to note that, in order to be effective, the ownership test must always be accompanied by the base erosion test. Otherwise, tax planning opportunities are exploited, in the sense that the ownership test requires a sufficient percentage of local ownership ensuring as a first tier that the beneficiaries of a transaction are residents of the contracting states, but it is necessary to take into consideration as a second tier the base erosion, since the treaty shopping can also arise when significant deductible payments are paid to related parties residents in a non-contracting state.

4.2.4. The active business test

The active business test applies to active conduct of a trade or business, that is, the company have to perform some substantive economic operations in the residence state, and not simply performing managing activities of its subsidiaries. Therefore, the LOB provision requires that the business activity performed in the residence state is substantial in relation to the business in the source state. The rationale of this provision is that the OECD presumes that treaty shopping is unlikely to happen in relation to active businesses. The OECD under this test assumes that a legal entity is subject to substantial tax in its country of residence, and that there is a strong relation between the business conduct in the state of residence and the income derived from the state of source, which leads the OECD to believe that the company is not serving as a conduit company to treaty shopping. Then, the active business test is based on the fact that when a transaction has economic substance, and is not artificially planned for tax avoidance purposes, it should not be considered as treaty shopping.

4.2.5. The Derivative Benefits Test

The derivative benefits test requires a certain level of ownership by equivalent beneficiaries. Under this test a company resident in one contracting state is entitled to treaty benefits if: (i) at least 95% of the aggregate voting power and value of its shares is, directly or indirectly, owned by seven or fewer equivalent beneficiaries (ownership test); and (ii) less than 50% of the company's gross income, as determined in the company's state of residence is paid to persons who are not qualified residents of either contracting state in the form of deductible payments (base erosion test).

4.2.6. The discretionary relief clause

The application of the discretionary relief, the tax authorities have a rather broad scope to determine when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining tax benefits was not one of the principal purposes of any arrangement or transaction, in order to grant treaty benefits. The discretionary relief gives the opportunity to identify after a serious analysis those legitimate structures that nevertheless fail to meet the LOB requirements, do not have the purpose to circumvent the treaty provisions in an inappropriate manner. On the other hand, grants wide discretion to the competent authorities to determine if a taxpayer can be granted tax relief under a tax convention, can render

meaningless the LOB provision, in the sense that the paragraph fail to provide objective criteria for the tax authorities to determine when the provision shall apply.

The criteria for a discretionary decision are laid out in the commentaries on the discretionary relief clause, establishing that the resident who is not entitled to treaty benefits may request the tax authorities of the country to grant the benefits to exercise its discretion, the competent authority is supposed to take into account all relevant facts and circumstances.

The proposal is not sufficient to provide specific legal basis to the discretionary relief, it seem to me that the commentaries provide through examples a guidance to tax authorities in reference to the facts and circumstances to be taken into account by the authorities in exercising its discretion, based mainly on tax business reasons. The OECD recognizes that is impossible to provide a detailed list of all the facts and circumstances that the tax authorities have to take into account to determine if the taxpayer is eligible for the discretionary relief, and encourages countries to adopt guidelines on the types of cases that should be considered to qualify for discretionary relief.

4.3. THE PRINCIPLE PURPOSE TEST

The OECD recognizes that a standalone LOB provision may not be enough to counter all the forms of treaty shopping. Therefore, the OECD proposed the inclusion of the PPT as an instrument to address other forms of treaty shopping not covered by the LOB clause. The PPT clause takes the form of a general anti-abuse rule, to prevent tax treaty abuse by testing the principal purposes of the transactions.

Paragraph 7 of the BEPS reports, states:

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

First, it is important to understand the meaning of the term benefit under this Convention included in the PPT rule. Paragraph 7 of the commentary on the PPT states that the rule includes all limitations on taxation imposed on the State of source under Articles 6-22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations.

On the other hand, after determining that the PPT rule is restricted to the scope of the corresponding tax treaty, it is important to remark that the PPT rule does not extend to the entire treaty, that is, if the PPT rule is applied, the benefit will not be granted in respect of an item of income. one can realize that the PPT rule contains two tests, (i) Subjective test, and (ii) Objective test:

4.3.1. Subjective test

According to the article, a benefit under the convention shall not be granted if after analyzing all the facts and circumstances, obtaining a benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

The current OECD commentary on article 1 to the Model Convention, it already contains guidelines regarding the main purposes of a given transaction or arrangements, stating that A guideline principle is that the benefits of a double convention should not be available where a main purpose for entering into certain transaction or arrangement was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant Provisions.

According to the paragraph 12 of the commentary on the PPT rule, the reference to one of the principal purposes in paragraph 7 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit .Now, when it comes to the application of the subjective test, we have to determine when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction.

It seems to me that to fulfil this part of the subjective test, taxpayers will face a difficult challenge, in the sense that even if the transaction or arrangement is motivated by different purposes other than tax benefits from a tax treaty, the arrangement will still fall under the scope of the PPT rule.

The main purpose of the Tax Conventions is to prevent double taxation, and tax avoidance, it is also true that another important objective of tax treaties is facilitate cross border transactions, so scholar find the OECD proposal contradictory to this purpose, especially having in mind that in my view, under normal circumstances, cross border transactions will always have as one of the purposes the access to treaty benefits, otherwise governments as representatives of its residents would not have an incentive to engage in the tax treaty in the first place.

one can assume that burden of proof is shifted to the taxpayers, due to the fact that even if the tax authorities are still required to proof that there is a presence of the tax benefit motivation (subjective element), they will not be obliged to find conclusive proof that the purpose of obtaining treaty benefits was one of the principal purposes. Therefore, to the taxpayers will not be sufficient to demonstrate that their arrangements or transactions were inspired also by motives different that tax benefits, they will have to proof that the tax benefit obtained in these circumstances is in accordance with the object and purpose of the relevant provisions of a certain Convention that is the objective test.

4.3.2. Objective test

Even if it is reasonable to conclude that one of the main purposes of the arrangements was obtaining a benefit, but it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention, the taxpayer as an exception can have access to the treaty benefits.

The OECD do not provide a reference to the “object and purpose” of the treaty. Therefore, the “object and purpose” of a treaty provision has to be interpreted in accordance with the “object and purpose” of the treaty in general.

Therefore, in this regard, one have to assume that in all cases of application of the rules of a certain tax treaty, those provisions must be applied in accordance with the object and purpose of the tax treaty.

4.3.3. Consequences of the PPT rule

The consequence of the PPT rule is that a benefit under this Convention shall not be granted. As stated before in the explanation of the PPT rule, the benefits refers only those under the corresponding tax treaty.

The denial of the benefits derived from the abused treaty provisions is the consequence of the PPT application. However, for instance once the source state establishes that the transaction falls within the scope of the PPT rule, the next step is to determine the tax treatment of the arrangements or transactions designed in the first place to access the treaty benefits. The proposed PPT rule in BEPS Action 6 does not provide guidance in this respect. However, in my opinion, based on the general criteria of the PPT rule, if the residence state considers that the PPT was not applied properly by the source state, the dispute, must be resolved through a Mutual Agreement Procedure (MAP).

CHAPTER – 5

BEPS ACTION 6 AND RECENT DEVELOPMENT

Minimum standards are the BEPS recommendations that all members of the Inclusive Framework have committed to implement, and they refer to some of the elements contained in: Action 5 on harmful tax practices, Action 6 on treaty abuse, Action 13 on transfer pricing documentation and Country-by-Country reporting and Action 14 on dispute resolution. The minimum standards are all subject to a peer review process. The mechanics of the peer review process were not included as part of the final reports on these Actions. Instead, the OECD indicated at the time of the release of the BEPS reports that it would, at a later stage, issue peer review documents on these Actions providing the terms of reference and the methodology by which the peer reviews would be conducted.

5.1. EXECUTIVE SUMMARY

On 1 April 2021, the OECD released two documents relevant for the implementation of the minimum standard on BEPS Action 6 relating to prevention of treaty abuse. The first document is the third annual peer review report on the compliance by members of the Inclusive Framework on BEPS with the minimum standard. The OECD also released revised peer review documents on BEPS Action 6 which will be used to carry out the peer review process beginning in 2021.

The minimum standard on preventing treaty abuse requires jurisdictions to include two components in their tax agreements:

- (i) an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; and
- (ii) one of three methods to address potential treaty shopping. The Report indicates that, of the three alternative methods, the vast majority of the jurisdictions have chosen to implement a PPT.

The Report includes information available as of 30 June 2020 and covers the 137 jurisdictions that were members of the Inclusive Framework by 30 June. Overall, the Report concludes that the majority of the Inclusive Framework members are translating their commitment to prevent treaty abuse into actions and are modifying their treaty networks. The Report covers 2,295 agreements in force among members of the Inclusive Framework, of which over 350 complied with the minimum standard by the cut-off date. In addition, over 1,300 of the 2,295 agreements were in scope of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS and were thereby set to become compliant with the minimum standard and a further 17 agreements are in the process of being updated bilaterally.

5.2. BACKGROUND

In October 2015, the OECD released the final reports on all 15 focus areas of the BEPS Action Plan.³⁰ The recommendations made in the reports range from new minimum standards to reinforced international standards, common approaches to facilitate the convergence of national practices, and guidance on best practices. The Action 6 report, titled Preventing the Granting of Treaty Benefits in Inappropriate Circumstances³¹, contains model tax treaty provisions and related changes to the model commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios.

On 29 May 2017, the OECD released the peer review documents for BEPS Action 6. The terms of reference reiterate that to be in compliance with the minimum standard on treaty shopping, jurisdictions are

³⁰ BEPS Action plan15,available at, <https://www.osler.com/en/resources/in-focus/base-erosion-and-profit-sharing-beps-action-plan-changes-to-the-international-tax-system>.

³¹ OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, (5 Oct 2015), available at, https://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

required to include in their tax treaties: (i) an express statement that the common intention of the parties to the treaty is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements; and (ii) an anti-abuse provision in the terms specified in “paragraphs 22 and 23 of the Action 6 final report”³². Jurisdictions can meet the minimum standard either by renegotiating their bilateral tax treaties and protocols or through the MLI. Partially compliant agreements — agreements that contain only one element of the minimum standard — are shown as non-compliant. Further, the Inclusive Framework agreed to evaluate the methodology for the peer review of the minimum standard on treaty shopping in 2020 based on the experience of conducting reviews in 2018 and 2019.

The first peer review was conducted in 2018 and covered the 116 jurisdictions that were members of the Inclusive Framework on 30 June 2018. Following that, the second peer review was conducted in 2019 and covered the 129 jurisdictions that were members of the Inclusive Framework on 30 June 2019.

5.3. THIRD ACTION 6 PEER REVIEW REPORT

On 1 April 2021, the OECD released the third Action 6 peer review report. The Report contains the following sections:

1. Executive summary
2. Implementation issues, the minimum standard and the MLI
3. Aggregate data on the implementation of the minimum standard
4. Difficulties in implementing the minimum standard
5. Conclusions and next steps
6. Data for each jurisdiction of the Inclusive Framework

The last section contains information for each jurisdiction on the progress made by the jurisdiction in the implementation of the minimum standard, any implementation issues that may have been reported, and a summary table on the jurisdiction’s response to the peer review questionnaire.

The Report reiterates that the BEPS Action 6 final report states that:

(i) a jurisdiction is required to implement the minimum standard in a treaty only if asked to do so by another member of the Inclusive Framework;

(ii) the decision on which of the three methods to adopt has to be agreed by the two jurisdictions (because a particular method cannot be forced upon a jurisdiction); and

³² Supra note no: 31 at 19

(iii) reflecting treaties' bilateral nature, there is no time limit within which a jurisdiction must attain the minimum standard.

5.4.MAIN FINDINGS

According to the Report, the 137 jurisdictions in the Inclusive Framework reported a total of 2,295 agreements between Inclusive Framework members, and 905 agreements between Inclusive Framework members and non-members. The Report includes the following aggregate data:

1. 98 Inclusive Framework members had some agreements that already complied with the minimum standard or that were subject to a complying instrument and would therefore become compliant shortly.
2. An additional seven jurisdictions, namely the Bahamas, the Cayman Islands, the Cook Islands, Djibouti, Haiti, Honduras and Turks and Caicos Islands, had no comprehensive tax agreements in force subject to the peer review.
3. 37 jurisdictions had not signed any complying instruments (i.e., the MLI or a protocol/treaty) to implement the minimum standard.

According to the Report, as of 30 June 2020, over 350 bilateral agreements between members of the Inclusive Framework complied with the minimum standard. An additional 20 agreements not subject to this review (i.e., agreements between Inclusive Framework members and non-members) also complied with the minimum standard. In all agreements between Inclusive Framework members that already comply with the minimum standard, the minimum standard has been implemented through the inclusion of the preamble statement and the PPT. Of those agreements, 31 supplemented the PPT with a LOB provision.

As of 30 June 2020, over 1,300 of the 2,295 agreements between Inclusive Framework members were set to become covered tax agreements under the MLI (i.e., because both Contracting Jurisdictions had listed the agreement under the MLI and, as a result, the MLI will modify the agreement once in effect) and were thereby set to become compliant with the minimum standard. The agreements that will be modified by the MLI will comply with the minimum standard once their provisions take effect. The Report also notes some gaps in the coverage of the MLI. About 200 bilateral agreements, concluded between pairs of signatories to the MLI that are members of the Inclusive Framework, would not be modified by the MLI because, at this stage, only one jurisdiction had listed the agreement under the MLI (one-way agreements). Also, there are about 325 agreements concluded between pairs of jurisdictions that are members of the Inclusive Framework where only one of them has signed the MLI (waiting agreements). None of these agreements would, at this stage, be modified by the MLI because one treaty partner has not signed the MLI.

The Report shows that jurisdictions that are members of the Inclusive Framework that did not sign the MLI or otherwise implement anti-treaty-shopping measures in their agreements have made no or very little progress in the implementation of the minimum standard. The Report thus highlights that signature and ratification of the MLI is an effective tool for jurisdictions that want to implement the minimum standard through the PPT. Furthermore, the Report encourages all signatories to the MLI that have not yet ratified it to do so. The Report also indicates that the OECD Secretariat has liaised with the signatories of the MLI that, at the time of the drafting of the Report, had not yet ratified it and notes that Bulgaria, Cameroon, Colombia, Croatia, Estonia, Greece, Hungary, Jamaica, Malaysia, Mexico, Morocco, North Macedonia, Romania, Senegal, South Africa, Spain and Turkey are aiming to deposit their instruments of ratification of the MLI by mid-2021.

According to the agreed methodology, a jurisdiction that encounters difficulties in reaching agreement with another jurisdiction to implement the Action 6 minimum standard has the opportunity to raise its concerns in writing to the Secretariat. During the course of the 2019 peer review, one jurisdiction raised a concern with respect to the Caribbean Community (CARICOM) Agreement, which is a multilateral agreement concluded in 1994 by 11 jurisdictions, 10 of which are members of the Inclusive Framework. Previous renegotiation attempts with respect to the CARICOM Agreement have proven to be difficult due to the fact that it contains several unusual features that are not found in the OECD Model Tax Convention or the United Nations Model Double Taxation Convention and that could lead to treaty-shopping practices. This concern remained in 2020 as the parties to the CARICOM Agreement have not yet modified it.

5.5. REVISED PEER REVIEW DOCUMENTS ON ACTION 6

The revised peer review documents on Action 6, which reflect the approach agreed by the Inclusive Framework for reviewing compliance with the Action 6 minimum standard from 2021 onwards, contain two sections:

1. The terms of reference, which are unchanged from the original mandate in 2017, and which set out the criteria for assessing the implementation of the minimum standard.

2. The revised methodology which sets out the procedural mechanism by which jurisdictions will complete the peer reviews from 2021. Changes were made in the methodology to establish a framework through which assistance by the Secretariat would be given to an Inclusive Framework jurisdiction that had non-compliant agreements that could, on its own assessment, create treaty-shopping opportunities and for which the jurisdiction had not yet taken steps to bring them into compliance with the minimum standard. The assistance would include a recommendation to formulate a plan if one was not already in existence.

The first step of the revised peer review process is carried out through a peer review questionnaire that each member jurisdiction of the Inclusive Framework is asked to complete before 31 May and that shows all the existing comprehensive treaties on income taxes of that jurisdiction that are in force at that time. For each

tax treaty listed, members are to indicate whether it complies with the minimum standard. Members of the Inclusive Framework are requested to provide additional information for each tax treaty that is not compliant and not subject to a complying instrument, more specifically information on whether:

- They plan to implement a detailed LOB provision.
- They have taken steps to enable the tax treaty to become subject to a complying instrument.
- It is established that a tax treaty does not give rise to material treaty-shopping concerns.

When a jurisdiction considers that a tax treaty could give rise to treaty-shopping opportunities and it has not yet taken steps to bring it into compliance with the minimum standard, it will formulate a plan to include the minimum standard in that tax treaty.

As part of the peer review process, the peer review documents describe that:

- The Secretariat will contact the jurisdictions that have tax treaties for which a plan for the implementation of the minimum standard needs to be developed.
- If a jurisdiction wants to implement the minimum standard through the PPT and some or all of its treaty partners are already signatories to the MLI, the Secretariat will provide support and encourage the jurisdiction to sign and ratify the MLI.
- For tax treaties that will not become covered tax agreements under the MLI or that are not covered by a general statement on the negotiation of detailed LOB provisions, the Secretariat will encourage the treaty partners to develop a plan, and where possible a joint plan, for the implementation of the minimum standard.

If a jurisdiction does not make a plan (or provide an update on the plan) to implement the minimum standard, a recommendation to provide a plan will be included in the peer review report with respect to the tax treaty. Once a plan is in place, the jurisdiction will provide an annual update if changes occur. A jurisdiction that is facing any difficulty in implementing the plan will be able to report such difficulty to the Secretariat.

Any jurisdiction member of the Inclusive Framework on BEPS that is facing difficulties in getting agreement from another jurisdiction to amend an existing treaty in order to implement the minimum standard will be able to raise that issue with the Secretariat, which will ensure that the other jurisdiction is offered the opportunity to present its views and that the case is discussed at the subsequent meeting of the Working Party 1 on Tax Conventions and Related Questions. Any such case where Working Party 1 considers that a jurisdiction is unwilling to respect its commitment to implement the minimum standard on treaty shopping will be forwarded to the Inclusive Framework on BEPS as part of the annual report on the implementation of the minimum standard on treaty shopping.

5.6.NEXT STEPS

The progress of the assessed jurisdictions will be reflected in peer review reports for the following year. The next peer review will be launched in the first half of 2021 and will also include the review of the new members of the Inclusive Framework.

According to the Report, it is expected that the revised Action 6 peer review methodology will be reviewed again in 2026.

5.7.IMPLICATIONS

The purpose of the peer reviews is to ensure the effective implementation of the agreed minimum standard on BEPS Action 6. However, the commitment to the minimum standard of BEPS Action 6 should not be interpreted as a commitment to conclude new treaties or amend existing treaties within a specific period of time. The peer review process will likely result in more countries renegotiating their tax treaties bilaterally and/or signing the MLI to meet the minimum standard.

As of 30 March 2021, 95 jurisdictions have signed the MLI, 65 jurisdictions have deposited their instrument of ratification and 1,700 tax treaties are covered by the MLI. By requiring Inclusive Framework members to develop specific plans to modify their non-compliant treaties and by offering assistance in the renegotiations, the OECD is enhancing compliance with the Action 6 minimum standard. The Action 6 minimum standard has several key impacts, including:

1. Structures developed before the widespread introduction of substantive anti-treaty-shopping measures should be reevaluated in light of the new developments in order to determine continued qualification for treaty benefits.
2. Many multinational enterprises have favored domestic dispute resolution processes for international tax matters because of the absence and/or unenforceability of effective bilateral Mutual Agreement Procedure (MAP) processes. As a consequence of BEPS Action 6 in the context of treaty-protected trade, MAP can be expected to improve, shifting the balance in controversy management from unilateral single-country approaches towards bilateral approaches such as MAP and/or arbitration.

Businesses should continue to monitor tax treaty developments with respect to BEPS Action 6 and the MLI.

Therefore we had clearly seen about the BEPS Action 6 Final report and The OECD/G20 Inclusive Framework on BEPS has a global membership, including about 70% of non-OECD and non-G20 countries from all geographic regions. With greater inclusiveness and participation, developing countries' perspectives and inputs are increasingly influencing the development of international standards on corporate taxation. As

such, capacity building support for developing countries is core to the Inclusive Framework, prioritising active, equal participation in the BEPS process. These are the tools available to developing countries

CHAPTER - 6

CONCLUSION

To Conclude my research, it is clear that the implementation of the LOB clause is a step forward to tackle treaty abuse, is not a perfect provision and therefore not entirely efficient measure that still can be circumvent by more elaborated tax planning schemes. Therefore, the PPT rule is an advantage for the tax administrations based on a discretionary approach to determine when a structure can be considered as abusive. Due to the complexity and highly administrative burden of the LOB provision, the states in their treaty negotiations can decide for the implementation of the PPT rule which is certainly more flexible, and easy to control. Also, the PPT place the burden of proof in the taxpayers, facilitating the administrative process to the tax administrations, affecting the playing field for the taxpayers.

From a tax administration perspective, the subjective test of the PPT rule can be relatively easy to asses, due to the discretion granted to the tax authorities. Nonetheless, it is important for the objective test to be structured in such a way that can provide some relief and uncertainty to the taxpayers. According to opinion of the scholar, the main obstacle of the PPT rule is that it seems to be tailored only for the interests of the tax administrations, however the introduction of such a general anti-abuse rule can be seen as an effective tool to deny treaty benefits to structures that appear suspicious to the tax authorities. If certain procedural measure is made out in PPT rule is subjective, unambiguous and creates certainty, which could produce more difficulties for the treaty shoppers.

Researcher opinion, is the truth of the matter is that the PPT will be an indispensable tool against the abuse of tax treaties, due to the fact that is not possible to fully objectify all the fact and circumstances that can give rise to tax avoidance or abuse of tax treaties in a more general manner. In order to reduce the level of uncertainty, the rule should contained more procedural measures. It is worth noting that states in the negotiating process can adopt the wording and measures in the clause that fit better to their interest and policies. Finally, whether the proposal contained in BEPS Action 6 will result in an effective tool to deny treaty benefits in inappropriate circumstances will depend on the ability of states to amend their bilateral tax treaties, and their willingness to include such provisions in further negotiations processes. Therefore, the PPT rule has a high subjective component that gives tax authorities the opportunity to address tax abusive schemes that the LOB clause could not deal with, but can create legal uncertainty among taxpayers, along with an objective test that is met as long as the granting of the treaty benefit would be in line with the object and purpose of the treaty provision.

6.1.FINDINGS

In light from the above discussion certain inferences made by the researcher on issues pertaining to measures to combat treaty shopping

- DOMESTIC TAX AVOIDANCE

Adopted Domestic Anti Abuse Provision in tax treaties may not be enough to handle all tax avoidance tactics, contracting countries must be addressed to Domestic Anti Abuse Measures that reflect the anti abuse requirements in their DTAAs.

- DISCRETIONARY RELIEF CLAUSE

Here, Tax authority possibility to grant treaty benefits to the taxpayers under discretion basis, to those who fails the test, but should be granted treaty benefits as the tax payer did not have as one of their purpose the obtaining of treaty benefits.

- TAX HEAVEN

The Corporate entities are adopting treaty shopping tactics and becoming treaty shoppers while deciding for the company (tax heaven) to be engaged in the transaction between other two companies only pay a limited percent tax rate, in certain circumstances they pay a nil tax rate.

- LACK OF CLARITY IN LOB PROVISIONS

The Limitation on Benefits clause have 5 test to tackle the treaty shopping eventhough there is no clarity and it cannot able to determine the taxpayer involves in a treaty abuse.

6.2.SUGGESTIONS

The following Suggestions are given by the Researcher on basis of the findings

- OECD MODEL CONVENTION

This convention was strictly to ensure the recipient of income to be the Beneficial owner of the income. If the convention made a certain clarity test included in the LoB provision then the benefits on passive income only granted to the resident of contracting states i.e.beneficial owner of that state.

- BEPS ACTION 6 REPORT

There are 3 action for recommended to attack treaty shopping. The main purpose of the tax treaties is not to be intended to generate opportunities for treaty abuse. This report incorporate a LOB. But this provisions are not sufficient then the next peer review report will need to discuss about the lack of clarity in LOB provisions.

- EFFECTIVE IMPLEMENTATION OF MINIMUM STANDARD

To express statement with common intention is to eliminate double taxation without creating opportunity for tax avoidance. This will need to focus for preventing the granting of treaty benefits in an inappropriate circumstances.

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