CHAPTER 11
TREATY SHOPPING

SYNOPSIS

'Here another great constant in economic life: as between grave ultimate disaster and conserving reforms that might avoid it, the former is frequently much preferred.

—Prof, John Kenneth Galbraith

A Short History of Economics The Past as the Present (p. 236):

I

1. The Concept of "Treaty Shopping" Explained

'Treaty Shopping' does not figure as an expression in the *New Shorter Oxford English Dictionary* (1993 edition). A treaty involves the following three elements:

(a) the meeting of the minds of the Contracting Parties;

(b) a reciprocal assurance to honour the terms of agreement emerging from the meeting of minds; and

(c) good faith is presumed to be at work.

Shopping means "goods that have been bought at a shop or shops" The expression "treaty shopping" was first used in congressional hearings on Offshore Tax Havens held in the United States in April 1971[1].

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[1]. David Rosenbloom, "Tax-treaty Abuse: Policies and Issues," *Law & Policy in International Business*, vol. 16, p. 783 (1983). Referred by Prof. Ray August in his *International Business Law* (4th Edn., 2004)

How can there be a shopping of treaty benefits? Can an outsider be entitled to benefits under a bi-lateral treaty? In some situations persons not party to a treaty may become beneficiaries of a treaty. But this can happen only when the fount of benefit in their favour is explicitly recognized under the treaty. In a multilateral treaty even those not party to the treaty can bear the benefits or burden if there is a general understanding to do so: the most glaring example is the UN charter itself. How can *good faith*, which supports and upholds the *pacta sunt servanda*, be sold? Such values are not wares to be traded on counters for the benefit of bad-faith purchasers. The trading would itself be dishonest. In fact, treaty benefits operate within the parameters of the law of obligations; and are clearly *res extra commercium*.

In the present day market economy everything is turned into merchandise, reminding one of a courtesan's song: *Yahan her Cheej Bikati Hain, Kaho Ji Kya Kya Kharidoge*? (Here everything on sale just tell me what you want?). The fundamental question relates to the nature of the market and the role of the government in close interactions. A society that is indifferent to a sound value system always totters at a precipice. Its structure is as fragile as that of a castle of sand under a hurricane.

A bilateral tax-treaty is a good faith arrangement for mutual benefit. Some contracting States may turn players in a wrong game by announcing to the bad faith purchasers their readiness to sell the benefits of a tax-treaty under a well-contrived opaque system. Dishonest purchasers may borrow garbs from a contracting party to masquerade as its residents. A legal regime is set up, and the administrative process is so operated as to ensure the subversion of the terms of a tax-treaty for ignoble consideration of commissions and other marginal benefits. A system that promotes corruption runs the gravest risk of getting corroded by worse corruptions. Hence, treaty shopping is a dishonest sale of benefits to a dishonest purchaser in a dishonest market for dishonestly causing wrongful gains him, and wrongful loss to others.

II

Treaty Shopping is improper use of a tax-treaty in breach of the Article on Personal Scope of the tax-treaty. Treaty shopping is in effect, taking advantage of the treaty by persons not within the Personal Scope of the treaty. Explaining the concept of treaty shopping Philip Baker observes[2]:

> "Treaty shopping consists of a state which is not a party to a treaty establishing an entity within a state which is a party in order to take advantage of the provisions of that treaty. The simplest example is the establishment of a "conduit company" in a Contracting State to receive income".

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[2]. Philip Baker, *Double Taxation Conventions and International Law* (1994 ed.) pg.91.

In short, it is a sort of shopping of benefits in black market. The author will give two illustrations:

(a) "The Indo-Mauritius DTAC was entered into for the encouragement of mutual trade and investment in India and Mauritius". The convention is bilateral, that is, between the two parties, being India and Mauritius. In the assessment order passed in the case of Messrs Cox & King, the Assessing Officer found that some Luxembourg residents took advantage of the Indo-Mauritius DTAC by routing its resources for transactions on the Indian stock market. It created an evidence of its paper presence in Mauritius without any economic impact there. The whole purpose was to earn capital gains on the Indian stock market without paying any tax in India or in Mauritius. The purpose of this strategy was to cause a wrongful gain to self, and wrongful loss to India.

(b) As per the Indo-U.K tax-treaty or the Indo-U.S tax-treaty certain taxes are payable by the residents coming within the scope of such treaty. In order to derive more benefits than what is due, several subterfuges are resorted to. The grossest of these is the misuse of the resort to the Indo-Mauritius DTAC. This act causes loss to their own country, and also to India. But Mauritius gets the best of all the worlds. It gets heavy fees and commissions without any responsibility under public international law about the juristic creatures. It would show its inability to trace the real owners. No purpose would be served by chasing shadows in the areas of darkness.

A classic pattern of treaty shopping is illustrated in two U.S. decisions. The first is the decision by United States Court of Appeals in the case of *Johansson v. U.S*[3]; and the second is the decision of the United States Tax-Code in *Aiken Industries, Inc. v. Commissioner* [4].

III

It is often said that the taxpayers "are free to arrange their economic affairs in the manner they deemed most beneficial to them. That a particular action has been taken for tax purposes cannot deprive the taxpayers in question of tax benefits to which they are otherwise entitled under the law. This rule applies if not universally, at least within all western constitutional democracies [5] ". The limits within which tax planning is permissible has been summarized by Prof. Klaus Vogel as under [6]:

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[3]. (1964) 336 F. 2d 809 (U.S.C.A. 5 Ct.).
[4]. (1971) 56 T.C.(U.S. Tax Court)- for a more recent ans very full analysis if this case, see P. James, "*Aiken Industries* Revisited" (1986)64 Taxes 131-146.
[5]. Klaus Vogel Pg.116. He refers several cases as the authorities for the proposition, one of the cases is *I.R.C. v. Duke of West Minister* (19 Tax cases 490, 510 U.K).
[6]. Klaus Vogel pg.116-117.

> "Tax Planning on the domestic or the international level is by no means objectionable, though extensive tax planning, it is true, is an indication of legislation being defective. Nevertheless, tax planning may reach a point beyond which it cannot be tolerated within a legal system intended to conform to principles of justice. Such limits may be reached where transactions are entered, or where entities are established, in other States, solely for the purpose of enjoying the benefit of particular treaty rules existing between the State involved and a third state which otherwise would not be applicable, e.g. because the person claiming the benefit is not a resident of one of the contracting States".

What Klaus Vogel writes is a very mild criticism of what, in effect, is a clear fraudulent practice. The following comments appear to me worthwhile:

(1) The judicial approach should be considered in the light of the observations in the various judgments in the case of *Furniss (Inspector of Taxes) v. Dawson* [7] rather then *I.R.C v. Duke of West Minister*.

(2) Treaty shopping is in breach of the accepted norms of International law; and so should be considered violative of International Public Policy.

(3) Treaty shopping is conceived in fraud and is executed in fraud. It causes wrongful gain to those not entitled to benefits of certain tax-treaty and causes wrongful loss to certain countries as they are swindled.

(4) Judiciary has shown a bold commitment to unravel fraud in all matters which come up for judicial consideration.

These points shall be developed in the course of this chapter.

One who wants to avail of benefits under a tax-treaty must come within the Personal Scope of that tax-treaty. The preamble of the Indo-Mauritius Double Taxation Avoidance Convention prescribes the object for which the tax-treaty was concluded. The object, as set forth in preamble is that the convention is "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment." Article 1 of the Convention determines the Personal Scopes. It says, "This Convention shall apply to persons who are residents of one or both of the Contracting States." The key word in the preamble is *mutual* which has been defined by the *New Shorter Oxford Dictionary* to mean "of a feeling, action, etc: experienced, expressed, or performed by each of the parties concerned towards or with regard to the other; reciprocal" Personal *Scope* determines the focus of the tax-treaty and limits the number of beneficiaries.

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[7]. [1984] 1 ALL ER 530.

IV

2. Beneficiaries under a Tax-treaty

All the tax treaties, which our Central Government has concluded, are bilateral tax treaties. They are the products of the meeting of minds (*consensus ad idem*) of the two Contracting States. The possibilities of a multilateral tax-treaty on the pattern of the various Conventions on the Laws of the Seas are yet to be seriously explored in our country. [8]

The fundamental legal principles which determine the Personal Scope of a treaty are fairly well settled both under International Law and within domestic jurisdictions. In the context of International Law, George Schwarzenberger has thus formulated the legal proposition[9]:

> "Treaties confer no legal rights and impose no legal duties on non-parties"

To the same effect is the statement of law summarized by J G Starke in his *Introduction to International Law*:[10]

> "As a general rule a treaty may not impose obligations or confer rights on third parties without their consent (Vienna Convention on the Law of Treaties, art 34), and, indeed, many treaties expressly declare that they are to be binding only on the parties. This general principle, which is expressed in the Latin maxim *pacta tertiis nec nocent nec prosunt*, finds support in the practice of states, in the decisions of international tribunals, and now in the provisions of the Vienna Convention (see arts (34-38)".

The Vienna Convention on the law of Treaties, 1969 sets out provisions pertaining to "Treaties and Third States" in section 4. Prescribing general rule regarding Third States Article 34 says: "A treaty does not create either obligations or rights for a third State without its consent." Article 2 (h) defines "third States": meaning *"a State not a party to the treaty."* Within domestic jurisdictions the same legal view prevails. Despite the facts that under Contract Act the definition of consideration is wider than that in English law, yet the Common Law principle is generally applicable in India. The effect of this principle is that only a party to the contract is entitled to enforce the same[11].

The Privy Council in *Kepong Prospecting Ltd. v. Schmidt.*[12] accorded its approval to the view of law stated by the Federal Court of Malaysia in regard to third party rights in the light of the decision of the House of Lord in *Dunlop Pneumatic Tyre*

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8. In course of some serious discussion about the protocol of a tax-treaty that I had with Dr. Nagendra Singh before his elevation to the International Court of Justice, Dr, Singh had suggested to explore the physibility of a multilateral Double Taxation Avoidance Convention. The idea is worth exploring though, I am sorry to say, I couldn't pursue this project to its logical conclusion.

9. *A Manual of International Law*15th ed. P.160.

10. Tenth Edition, p. 444.

11. (*Narayani Devi v. Tagore Commercial Corporation Ltd.*, (1973) AIR Cal 401, 405).

12. (1968) 2 W.L.R. 55. 64).

Co. Ltd. v. Selfridge & Co. Ltd.[13] The relevant case law from different domestic jurisdictions have been discussed in. Pollock & Mulla's *Indian Contract and Specific Relief Acts.*[14] The settled view is that the law contained in the Indian Contract Act does not differ from English law in admitting *jus quaestium tertio.*

The law on the Personal Scope of a treaty, as explained in the decisions of the House of Lords and the Privy Council, is accepted in the jurisprudence of both India and Mauritius. Hence, it is clear that a tax-treaty which violates domestic and international law of contract is void.

V

The OECD model, or the Commentary thereon contains no general anti-abuse provisions. But there are certain Articles in the Model, which describe certain anti-abuse provisions. Articles 10,11 and 12 require that the recipients of dividends, interest and royalties should be the *beneficial* owner of such income. " The commentary otherwise leaves the question of including anti-abuse provisions through bilateral negotiations within the Contracting States[15]". After taking note of the view of the Committee on Fiscal Affairs, as expressed in the Conduit Companies Report, Philip Baker writes:

> "Thus the report recognized that conduit companies would generally be able to claim treaty benefits. The Report discussed methods of combating the use of such companies through the existing provisions of the OECD Model, through safeguards which might be included in treaties, and through the extension of domestic anti-avoidance legislation to conduit company situations [16]."

The suggestions in the Conduit Companies Report 1987 submitted by the Committee on Fiscal Affairs of the OECD are not in accordance with the jurisprudence of the major countries of the world. They are not acceptable for the following reasons:

(a) It is erroneous to think "treaty benefits will have to be granted under the principle of *'pacta sunt servanda'* even if considered to be improper". Article 26 of the Vienna Convention on the Law of Treaties, dealing with *pacta sunt servanda*, says "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." Allowing third country nationals to sail under false colours causing wrongful loss to a contracting party is surely not in good faith.

(b) The Report "discussed methods of combating the use of such companies through the existing provisions of the OECD Model, through safeguards which might be included in treaties, and though the extension of

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13. (1914) All E.R Rep. 333, 335.
14. 11th ed. Vol-1, Page-41.
15. Philip Baker *Double Taxation Conventions and International Tax-Law.*
16. *ibid* at pg. 92.

domestic anti-avoidance legislation to conduit company situations." The view is based on complete misunderstanding of the Role of the Court in the administration of justice. Lord Scarman in *Furnis v. Dawsin* has brought out the correct approach. This is quoted it *in extenso* in the chapter: "The Pragmatics Of The Right Judicial Role".

(c) The anti-abuse provisions incorporated in the OECD model (Phillip Baker, pp-92-93) are merely illustrative. To specify that under specified circumstances the claimants of treaty benefits must be the beneficial owners, does not mean much as (it is merely to say the obvious) under the very fundamental principle of income-tax law only the *beneficial* owners are chargeable to tax. The fundamental principles of the Income-tax law cannot be modified by a tax-treaty done in exercise of the delegated executive power. Fundamental principles must be treated at work unless by express statutory provision it is abrogated, or over ridden.

(d) The importance of the domestic approaches to treaty abuse has been widely acknowledged. International Law cannot permit a triumph of fraud. This must be taken as a peremptory public policy in the comity of States. It is a virtual *jus cogens* in the *realm* of the International Law of Taxation. The Conduit Companies Report and the views of experts should have stated law on this point with more clarity and grater assertion. Philip Baker writes:

> "The Conduit Companies Report discussed the use of domestic anti-avoidance provisions to counter treaty shopping. *The Report concluded that the effectiveness of this domestic law attack would depend upon the issue of priority between domestic law and international treaty.*[17] The 1992 Commentary takes up this issue (at paragraphs 23-26) and records a divergence of views on whether domestic anti-avoidance approaches are applicable in the absence of specific provisions in the relevant treaty. The majority of countries in the OECD took the view that such approaches were applicable even without specific provisions. The Commentary also helpfully emphasizes that anti-avoidance measures must comply with the spirit and purpose of tax treaties to avoid double taxation." [18][Italics supplied]

(e) It is clear to any perceptive reader that German approach to the issue of Treaty Shopping has undergone a sea change. The conservatives and hide-bound approach, which was reflected in the decision of Bundesfinanzhof in the *Monaco* case, has been given up. This change in German law is clear from the analysis of the German approach as set forth by Klaus Vogel in his *A Commentary to the OECD-, UN-and US*

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17. This is discussed in Vogel, Intro., Paras. 112-124.
18. p. 94.

Model Convention for the Avoidance of Double Taxation on Income and Capital With Particular Reference to German Treaty Practice[19]*:*

> "In contrast, the new $ 50d Abs. 1a of the German EstG, in force since 1 January 1994, is directed against the abuse of double taxation treaties by foreign entities, rather than by resident ones. According to this provision, a foreign entity has 'no claim to tax relief' (including an exemption or tax credit under a DTC**) to the extent that.**
>
> - 'persons participate in the entity to whom the tax relief **would not be available** if they were to receive the income themselves , and
> - **there are no economic** or otherwise acceptable **reason**s for the interposition of the foreign entity, and
> - it displays **no economic activity of its own".**

(f) Klaus Vogel rightly considers that the purpose of Double Taxation Conventions is

> "…to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons ; they should not, however, help avoidance or evasion. True, taxpayers, have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between states and the tax advantages provided by various countries, taxation laws, but it is for the State concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws."

Klaus Vogel discusses various methods by which unintended benefits under a tax-treaty are not allowed to be enjoyed by unauthorised persons. He discussed 'look-through' provision to combat a conduit situation. Writing about the 'potential subject-to-tax' provision, he observes:

> "General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. While this seems adequate with respect to a normal interrelationship, a subject-to-tax approach might well be adopted in a typical conduit situation."[20]

VI

Some more comments on the *Monaco* Case, decided by Bundesfinanzof on Oct. 24, 1981, are well deserved. This German case has been analysed by Philip Baker but unfortunately it has not been evaluated under modern perspective. The fact-situation in this case is simple. A Monegasque citizen had shares in a

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[19]. Klaus Vogel on Double Taxation Convention, Third Edition, p. 128.
[20]. Klaus Vogel p. 112.

Swiss Corporation that owned share in a German Corporation. There was a treaty between Germany and Switzerland but there was no treaty between Monaco and Germany. The Swiss Corporation claimed reduction of withholding tax in terms of the treaty between Germany and Switzerland. The German tax authorities rejected the claim applying general abuse of law doctrine recognised in the General Tax Code. The German Court drew a distinction between the German residents and the non-residents. The residents bore full tax liability whereas the non-residents had a limited tax liability. The Court held that non-residents were not subject to the abuse of tax law provision. The Court said[21]:

> "the establishment of a corporation in a foreign country by a foreigner is a procedure not affecting the internal tax law and withdraws itself, as a matter of principle, from being considered as an abuse of forms and concepts of the law (See. 42 Abgabenordnung (General Tax Code) 1977)".

On this decision of the German Court, Philip Baker made the following observation:

> "This decision of the Bundesfinanzhof is consistent with the OECD's Conduit Companies Report which said that, in the absence of specific anti-abuse provisions in a treaty benefits would have to be granted to an interposed entity under the principle *pacta sunt servanda*."

The aforementioned view is unsound on principles, and is open to serious criticism at it fails in upholding what is fair and just:

(i) Philip Baker himself mentions in his book the decision of the IVth Senate of Bundesfinanzhof which conflicts with the decision in the *Monaco* case.

(ii) Klaus Vogel has discussed the subsequent development in German jurisprudence about which reference has already been made.

(iii) The classification drawn by the German Court between the residents and non-residents in matter of a tax-treaty abuse is unreasonable.

(iv) This sort of classification has no valid and fair nexus with the *object* to be promoted.

(v) The principle promoting anti-abuse provision of domestic law should have been used so that none could have availed of undeserved benefits. The German Tax Authorities follow the principle of fair play in the administration of tax laws. The French tax authorities come to the same conclusion by applying *les principes generaux du droit*.

(vi) The decisions of the domestic courts in most jurisdictions have settled principles to ensure that an abusive or fraudulent practice doesn't succeed.

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21. Quoted from *Philip Baker*, p. 100 who intern quotes the observation of the Court which H. Becker, quoted in "Treaty Shopping/ Treaty Override" (1988) E.T. 383.

VII

Neither the experts of the OECD nor distinguished scholars like Philip Baker and Klaus Vogel have tried to go to the root of the matter. The experts of the OECD worked under certain limitations: to mention a few--

(a) As an organization of the Western economically advanced countries the group of the OECD countries had certain hidden agenda to promote their interests. Their logic appears to be that unless the tax treaties have specific anti-abuse provisions, resort to treaty shopping can go on.

(b) The experts of the OECD suggest to reduce or eliminate treaty shopping specific terms be incorporated in the tax treaties. As an agreement on such points is not easy to arrive at, various variants have been suggested. It is difficult to resolve all perceptual differences amongst the States at various levels of economic development.

(c) But this type of approach does not appear to be fair and just from our-observation post. The treaty shopping is an act of fraud and so none should be allowed to avail of its fruits.

The core ingredient in the doctrine *pacta sunt servanda* is good faith. Article 31 of the Vienna Convention on the law of treaties clearly states:

> "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose."

The abuse of tax-treaty is subversive of good faith. Good faith has been thus defined in Black's *Law Dictionary* (7th Ed.) :

> **"Good Faith**, n. a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage"

The concept of *good faith* has been judicially interpreted in a lot of decisions. Its varied and context-dependent meaning is amply clear from the following exposition of this concept in Restatement (Second) of Contracts[22] quoted in Black's *Law Dictionary*:

> "The phrase 'good faith' is used in a variety of contexts, and it's meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the

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[22]. "In the United States the enormous bulk of reported cases from various states, all of them entitled to be cited in any court, has led to an unofficial Restatement of law, which is inevitably not merely encyclopaedia but an original work, in which many solutions are proposed for questions on which differing state precedents exit." AKR. Kiralfy "English Law" in An Introduction to Legal System, Edited by J. Duncan M. Derrett, p. 166.

> justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness of reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances." Restatement (Second) of Contracts $ 205 cmt. a (1981)."

The case of M/s. Cox & King Overseas Fund (Mauritius) Ltd. has been extensively dealt with in the chapter "Fraud unravels everything". It has been explained how a strategy was devised to avail of the benefits of the bi-lateral tax-treaty between India and Mauritius. The most beneficial provision under the treaty was the Mauritian residents could earn capital gains without paying tax in India or Mauritius. This favoured treatment was not only on account of a close bond of brotherhood that India had for century with Mauritius, but also because no serious poaching of the Indian Revenue was apprehended from a country like Mauritius when the treaty had been concluded in 1983. After the opening-up of the Indian Economy after 1991, Mauritius set up a new legal regime transforming herself into a tax haven. M/s Cox & King knew that there was no tax-treaty between India & Luxemburg. If it earned income in India it would be taxed as a mere non-resident. As a mere non-resident it was liable to pay heavy tax unless it is registered as a FII, in which case it is liable to tax in certain specific provisions.

VIII

TREATY SHOPPING is, hence, an attempt to cause wrongful gains to the persons not entitled to benefits under a bilateral tax-treaty: it amounts to a fraud, and is clearly against the mandatory Public Policy content of Public International Law, called *Jus cogens*. In France Conseil d'Etat frustrates fraud by invoking the doctrine of the "less principles *generaux du droit*." The Netherlands's Supreme Court (the Hoge Raad) in 1986 applied with impact the doctrine of *fraus legis* to the use of a conduit company. These two concepts have been explained in this book in the chapter on "Reading with Discrimination".

(i) Reductio Ad Absurdum

If *mere* incorporation under a Mauritian Law, or *mere* grant of a Certificate of Residence, be enough then nothing would prevent if Mauritius decides to provide that status, or to issue that sort of certificate, to every person on the globe who complies with the prescribed formality by paying some money to the government kitty. But if this happens then all other bilateral tax treaties would be reduced to irrelevance and the income-tax law would become a paradise for marauders leaving the people of India to rue their lot. This is not a figment of imagination of the author; it has already taken place. The Authority for Advance Rulings in a case reported as *XYZ/ABC Equity Fund, In re* , [2001] 250 ITR 194 is a recent case in which the applicant-company moved for rulings on certain points, describing itself as *a collective investment vehicle* resident in Mauritius. It is a *vehicle* which in modern commerce means: "A privately controlled company

through which an individual or organization conducts a particular kind of business, esp. investment" The Authority records in its order:

> "The applicant has stated in the petition before us that it is a private equity fund (similar to a venture capital fund). It has allotted a large number of shares on a private placement basis to a limited number of prospective investors spread over Belgium, France, Germany, Hong Kong, Japan, Kuwait, the Netherlands, Singapore, Switzerland, the United Kingdom and the United States of America."

If in the spacious "vehicle" an assortment from such large parts of the globe can sail together across the Indian Ocean to India, then why not construct a vehicle, registered in Mauritius, wide enough to be a Noah's ark where all the treaty-shoppers from all the parts of the globe can be accommodated, rendering all double taxation avoidance agreements, other than the Indo-Mauritius DTAC, irrelevant and otiose. The Indo-Mauritius DTAC should not be made the vanishing point of all other tax treaties. It is strange that what could have been at its best a mere *reductio ad absurdum* has already taken place with the culpable complicity of our own Government. It would be fair and just to take into account, while appraising the conformity of the situation to Art. 14 of the Constitution, the morbid effects of treaty shopping. Besides, it is in public domain that many Indian companies too are covertly following the treaty shoppers. When law gets diluted, and public morality is low, such *sinister* innovations abound; and none bothers about the morbid effect on our national interests.

IX

3. Treaty Shopping: how dealt with in other jurisdictions[23]

Professor Ray August [24] in a paragraph on "countermeasures" in his *International Business Law* (4th ed. 2004) gives a comprehensive account of how Treaty Shopping is viewed in other jurisdictions:

(i) Countermeasures

"The tax authorities opposed to treaty shopping have found solutions to the problem both in national legislation and through the use of specific anti-abuse provisions in tax treaties.

Only two countries have anti-abuse legislation: Switzerland and the United States. Switzerland enacted an anti-abuse ordinance in 1962 that suspends treaty benefits whenever a Swiss company makes a claim for a tax reduction that is

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23. The author is grateful to Prof. August and Dr Upadhyaya who were kind enough to furnish me information set forth in this Section of the Chapter.

24. Ray August, Professor of Business Law at Washington State University.

abusive[25]. A claim is abusive (a) if a substantial part of a Swiss company's income is given to persons not entitled to treaty benefits, (b) if a substantial share of the Swiss company is held by nonresidents, (c) if the Swiss company is an agent of a non-resident, or (d) if the income is given to a Swiss family foundation or Swiss partnership in which nonresidents own a substantial portion.

The U.S. Tax Reform Act of 1986 introduced a national treaty abuse provision that limited treaty benefits to companies that are "qualified" residents of either the United States or the foreign country that was a signatory of the particular treaty.[26] Unqualified corporations are those with more than 50 percent of their stock in the hands of residents of third-party states, or that disburse more than 50 percent of their income to third-party residents". [27]

But for us a matter of greater practical relevance is the judicial attitudes towards Treaty Shopping. Discussing this aspect of the matter Prof. August writes:

"In countries that do not have specific anti-abuse legislation, the problem of treaty shopping is attacked using general principles of equity. Common law countries (including Australia, Canada, and the United Kingdom) use a "substance over form" approach. That is, their tax authorities attempt to determine if the movement of income between foreign affiliated companies is based on legitimate commercial reasons or if it is merely a sham set up in order to obtain treaty benefits. Civil law countries (including France and Germany) use an "abuse" approach. In other words, their tax authorities ask whether a particular arrangement of companies constitutes an abuse, a misuse, or an improper use of a tax-treaty."[28]

It is a matter of great concern that our Supreme Court did not adopt the approach operative in the common law countries. Not only India is a common law country, its jurisprudence always unravels fraud. Besides, our country under its Constitution is committed to work for a welfare state in which economic decision makers are bidden not to forget Gandhi's talisman:

> "I will give you a talisman. Whenever you are in doubt or when the self becomes too much with you, apply the following test:
>
> Recall the face of the poorest and weakest man whom you have seen and ask yourself if the step you contemplate is going to be of any use to him. Will he gain anything by it? Will it restore him to control over his own life and destiny? In other words, will it lead to Swaraj for the hungry and spiritually starving millions?

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[25]. *Bundesratbesscluss betr. die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungs abkommen* (December 14, 1962), *Eidgenössische Gesetzesammlung*, vol. 1962, p. 1622, amended by *Kreisschreiben der Eidgenössischen Steuerverwaltung* (December 31, 1962).

[26]. United States, Internal Revenue Code, § 884.

[27]. *Id.*, § 884(e)(B). Special provisions are made for publicly traded corporations. Regardless of the stock ownership of the corporation, they will be treated as qualified residents if their stock is traded regularly and primarily on an established securities market in the signatory foreign state.

[28]. Deloitte, Haskins & Sells International, *Treaty Shopping: An Emerging Tax Issue and its Present States in Various Countries*, p. 7 (1988).

Then you will find your doubts and yourself melting away."[29]

(iii) Opinion on the question whether a bilateral treaty between two states affect the Nationals of a third state not a party to such treaty

This author felt that the core issue involved in Treaty Shopping, whether the third State national can take advantage of a bilateral tax-treaty?, be examined by an acknowledged legal expert of established standing. Dr M.L. Upadhyaya[30] was requested to examine the issue under a broad spectrum. The author is grateful to him for his comprehensive answer to the issue with which this author wholly agrees. The author is grateful to him for undertaking this love's labour wholly *pro bono publico.* His opinion is so valuable and illuminating that it is elected in *exteuso*:

"A bilateral treaty between the two states governs the rights and obligations of the state which are parties to such a treaty. Unless expressly excluded, treaties are interpreted in the manner provided by the Vienna Convention on the Law of Treaties, 1969. Article 34 of the said convention states the general rule regarding third states. It states that "a treaty does not create either obligations or rights for a third state without its consent." Article 38 however states that "Nothing in articles 34 to 37 precludes a rule set forth in a treaty from becoming binding upon a third state as a customary rule of international law, recognized as such". Article 35 states that an obligation for a third state arises if the parties to the treaty intend to do so and with the express acceptance of the third state of that obligation in writing. Article 36 states that the parties to the treaty may confer rights on the third state in the like manner.

Oppenheim's treatise on International Law, Volume I, ninth edition, (ed) by Jennings and Watts (First Indian Reprint) 2003 in Section 626 cites and analyses the provisions of Articles 34 to 37 of the Vienna Convention, illustrates their application and supports with relevant case law.

But we are not concerned with this discussion for the present purpose. We are concerned with the question as to whether a bilateral treaty between two states confers rights and impose obligations on the nationals of a third state or states who are not parties to such a treaty. Section 622 of Oppenheim op. cit touches upon this point to some extent. Section 622 states the effect of treaties upon individuals. It states the general rule unequivocally that "The binding force of a treaty and its effects concern in principle the Contracting States only, and not their nationals". Then it refers to the advisory opinion of the Permanent Court of International Justice that the intention of the contracting parties may by express or implied terms of the treaty provide otherwise whereby the treaty may be self

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29. As displayed in Gandhi Smriti, Birla House, New Delhi.

30. Prof. (Dr.) M L Upadhyaya, Vice President, Amity Law School President, Amity Law School *Former Dean, Faculty of Law:* Calcutta University and Jabalpur University:*Director,* Central India Law Institute, Jabalpur:*UGC Visiting Professor,*National Law School of India University, Bangalore.

executory and may bind the nationals and persons who are not nationals of the Contracting States. In all cases, if treaties contain provisions affecting rights and duties of persons on bodies under the jurisdiction of the contracting states, each Contracting states is required to take such steps as are necessary according to its constitutional law.

Lord McNair in his book on the *Law of Treaties* [Oxford the Clarendon Press, 1961 on pages 333] discusses the effect of a treaty upon the nationals of third state. In this discussion examples have been given from such treaties where the contracting parties had agreed to provide or create obligations on third states to cooperate in the matter of extradition of figures. All this is ensured by express terms of the treaty with the assent of the third states or by necessary implications.

Let us assume here that there is a bilateral treaty between the two states which does not contain any express term as to confer rights and impose obligations but has taken necessary steps in term of its constitutional law to make it part of its municipal law. Certain rights and benefits have been conferred upon its nationals, persons and bodies. The question further arises whether the nationals, persons and bodies of third states may avail of such rights and benefits. If they are complete strangers, not related in any manner with the contracting states, the answer would be clearly no. But if some façade of an artificial relationship is created solely and only to avail of such benefits, will it be legitimate use of treaty provisions or a fraud on the treaty?

Martin Dixon in his recent Textbook on International law sums up the law on treaties in the following words: -

> "The Vienna Convention represents a reasonably comprehensive statement of the law of treaties and there is no doubt that it has exerted a great influence on customary law, as well as regulating matters for the parties to it. Of course, in many areas, the Vienna Convention gives primacy to the terms of each treaty, but this is perfectly in accordance with the nature of treaties as instruments flowing from the Consent of States". (First Indian reprint 2001 by Universal Law Publishing Co. in arrangement with Blackstone Press Limited U.K)

Let us assume that two states have entered into a bilateral beneficial treaty securing certain benefits and advantages for their nationals only. There is no express or implied provision or suggestion to extend the benefits arising out of such treaty to the nationals of third States. In reality, the nationals of the third states pretending to be national entities of one of the contracting states claim such benefits. Objections are raised to such claims. If one of the Contracting States wants to condone this apparent illegal or unethical practice, how should it go about it. There are two courses open. One either the two states by consent amend the terms of the treaty and provide for by an express term in the treaty and then amend its laws, if the said amendments have financial implications affecting its revenues. But if the executive without amending the laws give a clarification of the provision of the treaty and the law and by executive fiat condones the manifestly illegal practice and does what was not initially intended by the treaty, it

would certainly be a fraud on the Constitution and a colourable exercise of power. This is clearly an attempt to do indirectly what it could not do directly."

To permit Treaty Shopping in India is clearly "a fraud on the Constitution and a colourable exercise of power". It is most unfortunate that this fraud could not be remedied in view of the decision of a Division Bench of the Supreme Court in *Azadi Bachao & Anr v Union of India & Ors* to be discussed in a separate Chapter. It is true that the Court did not appreciate it. It wantSt the Executive or Parliament to bell the cat. So it made a fervent *cri de Coeur* to them. The same Executive, which patronized treaty shopping, cannot be expected to provide an effective remedy. This faith that their Lordships had in the Executive, or even Parliament may be natural while reflecting over the problem sitting in the cool, serene and sublime courtroom. The common people of this country have no reason to share this perspective. As incorrigible optimists, they, bound on the wheel of fire of endemic sufferings, can only hope against hope.

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4. Great Expectations

(i) Will our Parliament pay heed to the Report of the CAG? "Our representatives, speak for India!"

The problem of Treaty Shopping has, in recent years, been considered at several levels.

(a) Our Supreme Court sustains Treaty Shopping as a necessary evil necessitated by the needs of the Market. It is clear that dissociation had set in the sensibility of the Court, between its moral imagination and practical sense dictated by the raw realities of this Market-driven world.

(b) The CAG in its 13th Audit Report 2005 the CAG has highlighted the misuse of several double taxation avoidance agreements in its masterly analysis without much assistance from the Income-tax Department. It has, in its Report submitted to the President of India under Article 151(1) of the Constitution of India, comprehensively examined the misuse of the tax agreements causing wrongful loss to our nation.

One thing emerges from both. The ball is now in the Court of Parliament. It must stop the evil of Treaty Shopping. It is so as:

(a) the Supreme Court in *Azadi Bachao* wants our Parliament to consider the evil of Treaty Shopping, and to provide a remedy against it; and

(b) the CAG, as an upholder of the Constitution, has reported to Parliament to act.

The author would examine the views of our Supreme Court and of the CAG in two separate chapters of this book. In a democracy Silence is complicity. And there is no way to escape its consequences. Whittier had said –

"For all sad words of tongue or pen
The saddest are these: It might have been".

5. Right Perspective

There is a school of thought, which considers that there is nothing wrong with Treaty Shopping. In the world we live genuine concern for general welfare of people is shamelessly discounted to favour the market forces. Revival of rabid capitalism believing in acquisitiveness and power is evident in the economic management in this phase of economic globalization. Those who profit by it advocate treaty shopping. The great economic powers are now under corporate domination. The corporate *imperium* has every reason to favour Treaty Sopping. Their hired experts and lobbyists work for them with no holds barred.

In the name of international solidarity and interdependence the interested persons are pleading for the primacy of the norms evolved or forged at international level.. Constitutional limitations are evaded. A specious plea is often advanced that the matters pertaining to international taxation operate at international plane, which are above the comprehension of ordinary mortals. Now there is a serious pursuit afoot to educate even the judges in the basics of market economy. Judiciary, like all other organs of the State must be made market friendly. In this sort of environment, often Treaty Shopping is not considered evil. All sorts of arguments are spun. Under our Constitution we had built a dyke against arbitrary power. Treaty Shopping violates Art 14, 19 and 21 of our Constitution. No precedence from a foreign land, no opinion of the OECD or non-OECD experts can stand against our Constitution. The Executive has no hip-pocket of extra-constitutional power to be used at an international plane to wreck out, or gloss out, the Constitution. It would be a morbid betrayal. Justice and equity may not be comrades in love, they are surely not at loggerheads with each other. Treaty Shopping is not a mere tax law issue; it affects the country adversely in many other ways. We must pass through the market transacting in wares, but we should not ourselves become wares for sale. It is good

(a) that in *Azadi Bachao* our Supreme Court wants the Executive and Parliament to provide a remedy against the evil Treaty Shopping;

(b) that the Common Minimum Programme of the UPA Government states in its programme: "Misuse of double taxation agreements will be stopped";

(c) that the CAG in his Report 13 of 2005 suggests effective action to stop Treaty Shopping.

Despite a lapse of substantial time nothing has been done. Let not such market-forces overtake us under which the treaty shoppers, money-launderers, and fraudsters can plead by invoking Psalms:

Keep me as the apple of the eye;
Hide me under the shadow of thy wings

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And oftentimes, to win us to our harm,
The instruments of darkness tell us truths,
Win us with honest trifles, to betray's
In deepest consequence.

—Shakespeare, *Macbeth* I.iii.123