CHAPTER 12
SUPREME COURT ON TREATY SHOPPING

SYNOPSIS

Between the idea
And the reality
Between the motion
And the act
Falls the Shadow

—T. S. Eliot says in his "*Hollow Men*":

I

1. Supreme Court on Treaty Shopping

What led to the filing of a PIL before the Delhi High Court is an absorbing story turned into the stuff for a separate Chapter. Sufficient it is for the context to say that whilst *Azadi Bachao Andolan* targeted the Circular 789 of April 13, 2000 issued by the Central Board of Direct Taxes[1], this author as a petitioner-in-person challenged not only the Circular but also the misuse of the Indo-Mauritius Double Taxation Avoidance Convention (DTAC, for short). The Delhi High Court in its judgment dated 31 May 2002, under the cause title *Shri Shiva Kant Jha & Anr v. Union of India & Ors* quashed the said Circular and declared law on various points touching the tax treaty. The Writ Petitions were fully allowed. But, on an appeal by the Union of India and its Mauritian co-Appellant, entering appearance for the first time before the Supreme Court, the Supreme Court reversed the judgment and quashed the said Circular holding that the High Court "erred on all counts". The cause-title was changed to *Union Of India & Anr v. Azadi Bachao Andolan And Anr.* Union of India, while filing appeal, chose to doctor the cause-title (vide fn. 5 of the "Introduction") containing *Shiva Kant Jha* into a mere 'Anr'.

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[1]. [2000] 243 ITR (St.) 57.

On Treaty Shopping the Delhi High Court had held:

(a) "An abuse of the treaty or Treaty Shopping is illegal and thus necessarily forbidden."

(b) The Indo-Mauritius Avoidance of Double Taxation Convention was entered into between the Government of the Republic of India and the Government of Mauritius for avoidance of double taxation and the prevention of fiscal evasion with regard to tax on income and capital gains and for encouragement of mutual trade and investment.

(c) "Treaty Shopping which amounts to abuse of the Indo-Mauritius Bilateral treaty may amount to fraudulent practice and cannot be encouraged."

(d) The company although had obtained residential certificate in Mauritius but had nothing to do therewith and factually. It got itself registered only for the purpose of tax avoidance so as to obtain benefit of the treaty.

(e) "No law encourages opaque system to prevail."

Delhi High Court rightly considered Treaty Shopping as the core issue in the PIL. It is curious to note that this core issue was evaded by the Central Government before the High Court. Mr. Salve, the then Solicitor-General, never took a position on this issue. Out of evident disgust the High Court was led to make the following crucial comment in its Judgment:

> "The core issue is as to what should be done when on investigation it is found that the assessee is a resident of a third country having only paper existence in Mauritius without any economic impact with a view to take advantage of the double taxation avoidance scheme. No attempt has been made to answer the question on behalf of the Central Govt……."

D.G. Rossetti had written to Hall Caine: 'Conception, my boy, *fundamental brainwork*, is what makes the difference in all art.'[2] So it is worthwhile to find out what formed the judicial conception, which led the Supreme Court to sustain Treaty Shopping in *Aazdi Bachao*. The judicial conception which led the Court to sustain Treaty Shopping is set forth immediately after three long paragraphs[3]

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[2]. Quoted in Caine's *Recollections of Rossetti.*

[3]. "Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology.

(Footnote No. 3 Contd.)

quoted in *Azadi Bachao in extenso* from Rohatgi's book *Basic International Taxation* about which the author written in a separate Chapter, "Reading with Discrimination". After quoting three paragraphs from *Basic International Taxation* the Division Bench of our Supreme Court observed--

> "There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; Treaty Shopping, in our view, is another. Despite the sound and fury of the Petitioners over the so called 'abuse' of 'Treaty Shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of Treaty Shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy."[4]

How wise was Justice Holmes who in his classic dissent in *Lochner v. New York*[5] said:

> "This case is decided upon an economic theory which a large part of the country does not entertain. If it were a question whether I agreed with that theory, I desire to study it further and long before making up my mind."

The issue at the heart of *Azadi Bachao* could have been decided on reasonable statutory construction alone rather than by adopting a holistic view as suggested by Roy Rohatgi. The High Court had decided the issue under litigation as a matter of construction. Hood Phillips explains how the examination of *vires* can be effectively done through the technique of interpretation. He observes: [6]

They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc.

Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit". Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty.

Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses. (Roy Rohatgi, *Basic International Taxation*, pages 373-374 (Kluwer Law International)).

4. (2003) 263 I T R 706 , 753].
5. (1904) 198 U.S. 45.
6. O. Hood Phillips' *Constitutional and Administrative law* 7th ed. P. 662.

> "As regards the innumerable statutory powers, the question is one of interpretation of the statute concerned. The acts of a competent authority must fall within the four corners of the powers given by the legislature.[7] The court must examine the nature, objects and scheme of the legislation, and in the light of that examination must consider what is the exact area over which powers are given by the section under which the competent authority purports to act."[8]

And Lord Hoffmann in a leading decision of the House of Lords states with remarkable terseness:

> "There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other principles of construction can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation."[9]

The High Court construed the provisions of the Income tax Act, especially sections 119 and 90, and evaluated the impugned Circular[10]. The Court declared certain vital points of law, and held the impugned Circular bad as it violated them. The Court held the impugned Circular *ultra vires* the powers of the CBDT as it was not a proper exercise of *administrative* and *managerial* power. It prevented the statutory authorities in due discharge of public duties by issuing instructions trespassing on the legislative field. It created an opaque system under which Treaty Shopping could flourish causing unjust enrichment and wrongful gains to the Treaty-shoppers and their mentors, and causing wrongful loss to the people of India. The Central Board of Direct Taxes's Circular No. 789 dated April 13, 2000 mandated an opaque system by creating administratively two conclusive presumptions, which completely restrained the statutory quasi-judicial authorities to explore the operative realities in a given case to see whether claims for benefits were in order. The object of this Circular was, admittedly, to help the FIIs, and the MNCs operating through the Mauritius route who through stealth and stratagem intended to take advantage of the bilateral tax treaty for mutual benefit between India and Mauritius. The Delhi High Court quashed the said Circular after a broad-spectrum exposition.

But the Supreme Court reversed the view that the High Court had taken. It felt that the High Court had gone wrong on all the points! The High Court stressed on legality. The Supreme Court had an economic theory to propound. It acknowledged the rule of market forces. It found a lot of sense in the Attorney-General's plea that everything deserved to be done to attract the foreign investors. The Court was persuaded not to do anything that retards the government's market-friendly policies in the economic realm. . The expression *holistic* is meaningless unless we know whether the common suffering souls of this country are

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7. Per Lord Greene M.R. in *Carltona Ltd v. Commissioners of works* [1943] 2 All ER 560, 564.
8. Per Sachs J., *Commissioners of Customs and Excise v. Cure and Deeley Ltd.* [1962] 1 Q.B. 340.
9. Westmoreland Investments v MacNiven [2001] I All ER p. 865, at 874; [2002] 255 ITR 612 at 623.
10. Circular No 789 of April 13, 2000 issued by the Central Board of Direct Taxes.

within this *holos* (the whole), or they are out of it! In Rohatgi's *holos* Gandhi's talisman stands sold for a song. General J.C. Smuts, the author of *Evolution and Holism*, would have shuddered at the use of this word so made. It is quite understandable for the former partner of Arthur Anderson, to invoke holism to drape its design. But it baffles us most when it rings in the judgment of our Supreme Court. It is easy to find that the genesis of the ideas, which endeared themselves to the Court, is in the three long paragraphs, which Rohatgi had so dexterously penned. Section 90 of the Income-tax did not enact Rohatgi's philosophy of holism. The author would be failing in his public duty if he does not evaluate those nuggets of thought. He must do this with candour, but with utmost respect:

(i) The assumptions about the 'many principles of fiscal economy' are all *ex cathedra*, as they were never put as an issue for deliberation in the course of hearing. Besides, its rationale in sustaining Treaty Shopping is not clear. The expression fiscal means "belonging or relating to *government finance* or revenue". Perhaps, the hypothesis is that the loss of revenue matters not, if non-tax benefits [a concept which conceals more than what it reveals] are received. It is forgotten that the revenue of a country goes to the Consolidated Fund of the country to be used for public purpose under Parliamentary authorization or approval. It is the nation's wealth. The country which takes seriously the conditions of people think about revenue the way Viscount Simonds thought when he said in: *Collco Dealings LTD v. IRC*, [1961] 1 All E R 762 at 765:

> "But I would answer that neither comity nor rule of international law can be invoked to prevent a sovereign state from taking steps to protect its own revenue laws from gross abuse or save its own citizens from unjust discrimination in favour of foreigners."

(ii) The Supreme Court has not mentioned the name of such developing countries, which tolerate the embarrassment of evil for some larger cause. Roy Rohatgi mentions them in his book wherefrom the Court quotes three long paragraphs. The countries mentioned are: Cyprus, Madeira, Singapore, and Mauritius. Bertrand Russell had written that "proportionality" is an attribute of wisdom; Lord Diplock had wrung out the principles of *proportionality* as one of the four counts of Judicial Review. The Great Republic of India is surely in some morbid plight when *Roy Rohatgi* tries to prove his point with reference to such tiny tots of our terra firma. Cyprus is a country of 873000 people craving for the membership of the European Market ever ready to compromise its values for its mentors. Madeira's existence was unknown to this author despite his credentials to write on geography. It is a group of island belonging to Portugal having not more than 264800 persons without tradition and jurisprudence. It is known to the wine-addicts for its wine. Its name itself means 'wine'. Singapore, a country of 264 sq. miles has a population of 3322000 people excluding the newly arrived 808000 non-residents where the press presses people:" Let's Get on the Love Wagon." And Mauritius: an area of

2040 sq kms and population of 1195000. It has preferential access to the U.S. and European Union markets under, respectively, the Africa Growth and Opportunity Act and the Cotonou Agreement. Madeira shot to fame for its wine. It is not to shoot it down in flames but to show how atrocious a comparison can be. The Central Government evaded realities and allowed third country residents to sail under false colors under *residence* of culpable convenience, effecting through fraudulent practice of Treaty Shopping incalculable and immense wrongful loss to India and wrongful gain to themselves. It is shocking that despite vast socio-economic differentials, India is to be counseled the way *Roy Rohatgi* has done. Besides, the fundamental error in analogy, this is a disrespect to our country. We are not the birds of the same feathers. McReynolds observed:

> "Loss of reputation for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling."[11]

Our Court, which has great concern for an individual's right to reputation, failed to recognize it when some mercenaries of market slighted our Republic.

(iii) If the doctrine of toleration of Evil "in the interest of long term development", is allowed to have a grip over our thinking, even God would leave us to groan under the Slough of Despond. History is a witness deposing that this is the doctrine of supreme justification by the dictators, tyrants, crooks, and scamsters in all times, and in all lands. Hitler destroyed the Weimer Constitution justifying his act as a necessary evil to wipe out the disgrace that the Peace Treaty of Versailles. Mrs. Gandhi justified the ignominious Emergency by drumming into our ears the shibboleth of Necessary Evil till the gongs of thallis from Bihar drowned the drum. The doctrine of Necessary Evil is against the grain of our society and our great tradition.

(iv) The author respectfully submits that the following observation was not fair to the common people of this country:

> "A holistic view has been taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy."

The expression "holistic view", as this Petitioner has already submitted, is a meaningless expression with sinister overtones. The idea that Treaty Shopping is justified as a "necessary evil" is repugnant to our moral sense without which a democratic polity is doomed to decay. It is not for nothing that the process of justice at apex level unfolds itself between the two metaphors of profoundest suggestions: the words of Gandhari

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11. McReynolds, James C., in P*erry v. United States*, 294 U.S. 330, 381 (1935).

(*Yatoh dharmah tato jayah*) and the statute of Mahatma Gandhi[12]. *Holism* is a doctrine of a suffocating intellectual error (vide Russell, *Hist. Western Phil.* Hegel p.714). Ordinary men and women could understand Satan saying, "Evil be thou my good", but they would be at their wit's end to find the spokesperson of the Union of India saying so. It is just a step further where we would cant 'Lawlessness be thou our guide.' The central light of the Budapest Sunday Circle[13], George Lukas, like Kant, endorsed the primacy of ethics in politics[14]. This is what Mahatma Gandhi had said, which is now announced on the board in Gandhiji's Wardha ashram. To justify something on the specious plea of Necessary Evil is to reject the central ideas of John Rawls expressed in *A Therory of Justice* often referred to by the courts in our country.

(v) The Court should not have seen an analogy between deficit *financing* and *Treaty Shopping* as these are two concepts operating on different considerations in different fields of economic discourse. *The Encyclopedia Britannica*, writing about *deficit financing:*

> "practice in which a government spends more money than it receives as revenue, the difference being made up by borrowing or minting new funds. Although budget deficits may occur for numerous reasons, the term usually refers to a conscious attempt to stimulate the economy by lowering tax rates or increasing government expenditures. The influence of government deficits upon a national economy may be very great."

'Treaty Shopping,' on the other hand is a dishonest sale of benefits to dishonest purchasers of such benefits in a dishonest market for dishonestly causing wrongful gains to those not entitled to them, and wrongful loss to those legally entitled to benefits. To say that *Treaty Shopping* is good for economy is an erroneous notion. Impartial experts have done a lot of sound work to demonstrate the deleterious effect of getting foreign funds by hook or by crook.

(vi) The Court appears to have accepted the submissions both of the Attorney-General for India (Mr. Sorabjee) and the lawyer of the tax haven

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12. Mahatma Gandhi had said (as displayed in Gandhi Smriti, Birla House, New Delhi)
[quoted by G. Austin in his recent work on the Indian Constitution]:
"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? Then you will find your doubts and your self melting away."

13. Its other members were Arnold Hauser, Karl Mannheim, Bela Balazs, Anna Leznai, Bela Bartok.

14. Arpad Kadarkay, *George Lukas, Thought and Politics* p. 195 (Oxford).

company (Mr. Harish Salve) that the Indo-Mauritius DTAC was *intended* to be used for Treaty Shopping. The Court observed in the judgment:

> "Despite the sound and fury of the Petitioners over the so called 'abuse' of 'Treaty Shopping', perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into."

To 'intend' is 'to plan or have in mind as one's purpose or aim.'(*Chambers 21st Century Dictionary*). It had been asserted that this assertion was false as there was nothing, there could be nothing, to prove it, or even to suggest on the principle of probability. Mr. Salve had been paid for to plead whatever could advance his client's case, fact or fiction. But it was shocking to find the Attn.-General doing that. The unstated but dexterously suggested idea was to free the BJP government (and its then Finance Minister of India, Mr. Yashwant Sinha) from the remissness in promoting Treaty Shopping, and to put the blame on the Congress as the Indo-Mauritius DTAC had been signed when Mrs. Gandhi had visited Mauritius 1982 along with Mr. Pranab Mukherjee, the then Finance Minister. It was unbecoming of both the counsels to suggest this, even in pregnant aside. The Court was not the appropriate forum for playing politics. They brought out no *travaux preperatoires* (preparatory work). They brought nothing to suggest even remotely to prove this sinister suggestion. A DTAC founded on the mutuality principle is never, nowhere, used for the benefits of the treaty-shoppers. This author as the petitioner had investigated how the Indo-Mauritius DTAC was entered into; and had reasons to assert that this plea was baseless, hence false. It is submitted that the Court committed a mistake of fact by stating that the abuse of Treaty Shopping, "perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into." This conclusion is based on no material.

The Indian Constitution is not based on the rigid doctrine of separation of powers, as is the U.S. Constitution. We have structured our polity on the British model.[15] Under this system judicial creativity is very wide. It is attested by the judicial activism shown by our courts. The problem of Treaty Shopping is, in fact, more amenable to judicial creativity. The core question in the case, as the High Court said, was the abuse of the DTAC by those not entitled to it for the purpose of causing wrongful gains to themselves and wrongful loss to our country. Developing domestic anti-abuse provisions in course of judicial process could have rooted out this abuse. It is to be noted that the Doctrine of the Lifting of Corporate Veil, was evolved by the courts, not by the legislature. There is no reason why the Court should narrow down its vibrant creativity in a phase wherein the nation needs it most.

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15. *Ram Jawaya Kapur v. Punjab*, AIR 1955 SC 549.

(vii) Everybody knows that the Indo-Mauritius DTAC was systematically abused to the full knowledge of the Executive. There are good grounds to believe that whichever be the political party in power, the lot of the country is just to be looted. [The story would be told in a separate chapter.] Once the sinister realities came to public knowledge, the Executive should have responded. In *Furniss* it was very aptly stated that measures to eradicate tax avoidance were more suited to be evolved through judicial creativity than through the blunt instrument of the legislature. Lord Mansfield, stated the functions of the King's Court, as far back in 1774, in these words:

> "Whatever is contra bonos mores et decorum, the principles of our law prohibit, and the King's court, as the general censor and guardian of the public manners, is bound to restrain and punish."

(viii) Our Supreme Court observed in its judgment in *Azadi Bachao*:

> "Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations."

Economic and political considerations do determine the governmental policies. It has already been stated that under the income-tax law the governmental policies are legislatively enacted in precise terms. Open-ended power is not given to the executive. Amongst the tax laws, the income-tax law is *sui generis*. If the Executive is entrusted with powers to tax or un-tax then the Stuarts are on return. That the world in which the Executive is granted a wide unanalyzed power is a dangerous world. The author in one of his articles had written:

> "The globalisation has spawned a new style of corruption. Before it whatever was earned from improper sources was kept in the country itself. Because of mass communication, information technology, and closer interactions in matters of commercial dealings, the fruits of corruption are gathered and amassed more often outside the territorial jurisdiction of India. The FIIs, the MNCs, and the OCBs, through their rich band of lobbyists provide a very stable system to indulge in corrupt practices on global basis. The country's vigilance commission is totally outdated. The experts are in plenty to function on hire as their fund managers investing such resources in movable or immovable property from the North Pole to the south, perhaps exploring ways, if technologically feasible to transmit the bags of ill-gotten wealth in some vaults in the Sea of Tranquility on the Moon or some other Planet."

The entrustment of unbridled wide power to the Executive bodes ill for our democracy. It was essential for the Court to adopt a pragmatic view of how the government is going to behave under pressure, persuasion, and temptation of all sorts which abound these days all around. In a situation of this kind the following nuggets of thought must resonate in our mind:

(a) Chandrachud C.J aptly said:[16]

"Besides, as observed by Brandies J., the need to protect liberty is the greatest when Govt.'s purposes are beneficent."

(b) Wade & Phillips rightly says[17]:

"These decisions established the fundamental principle that

state necessity does not justify a wrongful act."

(c) The Supreme Court of India in *S.R. Chaudhary v. State of Punjab*[18] observed:

> "There can be no constitutional government unless the wielders of power are prepared to observe the limits upon governmental power."

This judicial *cri de Coeur* amouts to telling the Executive: You have caused the distress: you come out with panacea. It is "against hope believed in hope."

(ix) The Court was less than fair in saying that the "Court cannot judge the legality of Treaty Shopping merely because one section of thought considers it improper". It is respectfully submitted that it is **not a sectional thought**; it is the considered view of those for whom the country matters more than the lust for wealth. The Report of the Joint Parliamentary Committee and the Report of the Comptroller and Auditor General of India (No 13 of 2005), and the information in public domain would show that what was being projected was not a sectional thought. What Treaty Shopping means to the people of this country can be stated in these words?

> "Such matters cannot brook any delay, as the security of the country must be of supreme interest. The price of liberty and societal weal is always eternal vigilance. The Government must respond not only by withdrawing the aforementioned Circular but should also take all possible steps to see that there is no unjust enrichment, there are no recipients of wrongful gains, there are no sufferers on account of wrongful loss. It would be a queer irony that the government, which rightly asserts its case against terrorism, tends to become, perish the thought, a facilitator of terrorism! It would be foolish to wait till facts are proved beyond a reasonable doubt. When the issues relate to the security of the country a responsive and reasonable government should act on express probability itself."

Besides it has many more sinister effects for us, but this aspect of the matter would come up for more concentrated exposition in some other Chapter.

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16. AIR 1980 S C ,1808-1809.
17. *Constitutional and Administrative Law* 9th ed p.445.
18. 2001 (7) SCC 126.

It is interesting to note that the Court's view on Treaty Shopping shaped its view on other crucial issues decided in *Azadi Bachao,* and led it, it is submitted, to several errors:

(i) Once it was held that a tax treaty is to promote political and economic ends of the government of the day, it was natural and logical for the Court to hold that even a tax treaty is made in exercise of the executive power contemplated in Art. 73 of the Constitution of India.

(ii) Once the doctrine of necessary evil was recognized, the core issue stood by express logic decided: that Treaty Shopping is not illegal.

(iii) That the Court narrowed its jurisdiction and compromised its creativity by subjecting it to the Blackstonean frontiers prescribed in the doctrine *Judicis est jus dicere, non dare* (now anachronistic and rejected by this Court in several Constitution Bench decisions). It is only by virtually eliminating its judicial creativity that the Court could pass on the buck to the Executive, or Parliament.

(iv) It also follows as a day follows night that the Court should show preference for hyper-technical reasoning which the Court generally rejects in doing complete justice.

(v) But the judicial logic could not advance unless *McDowell* is interpreted out of existence. At least the Constitution Bench Decision stands doused with cold water. If this decision would have prevailed in its full majesty, Treaty Shopping could not have been sustained. So it is glossed out as a mere 'hiccup' or a 'temporary turbulence'.

(vi) But without subjugating law to the act of the Executive [whether a DTAC or circulars] the approved judicial thesis could not have been advanced. But the outcome is strange. Executive's acts rank supreme. The Court held that both the tax treaties and the circulars are above law (by necessary implications, even above our Constitution.). If a treaty is above law, the Executive at international plane becomes above all laws and constitution.

For upholding Treaty Shopping the Division Bench of the Supreme Court in its judgment in *Azadi Bachao* advanced the following three basic reasons:

(a) The opinion of Lord McNair in Chapter 17 of his *Law of Treaties;*

(b) The views set forth in the Conduit Companies Report 1987 submitted by the Committee on Fiscal Affairs of the OECD; and

(c) The book by Roy Rohatgi, *Basic International Taxation.*

2. Lord McNair's view examined

In *Azadi Bachao* the Supreme Court justified Treaty Shopping quoting the high authority of Lord McNair. The Court observed:

> "Treaty shopping" is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States. According to Lord McNair, "provided that any necessary implementation by municipal law has been carried out, there is nothing to prevent the nationals of 'third States', in the absence of any expressed or implied provision to the contrary, from claiming the right or becoming subject to the obligation created by a treaty" (Lord McNair, The Law of Treaties, page 336 (Oxford, 1961))."

And then the Court quotes the following paragraph from Lord McNair's *The Law of Treaties* Ch XVII in the support of its view of Treaty Shopping:

> "*Provided* that any necessary implementation by municipal law has been carried out, there is nothing to prevent the nationals of 'third States', in the absence of any express or implied provision to the contrary, from claiming the rights, or becoming subject to the obligations, created by a treaty; for instance, if an Anglo-American Convention provided that professors on the staff of the universities of each country were exempt from taxation in respect of fees earned for lecturing in the other country, and any necessary changes in the tax laws were made, that privilege could be claimed by, or on behalf of, professors of those universities who were the nationals of 'third States. Conversely, unless an extradition treaty between two States contains any express or implied provision to the contrary, neither the nationals of 'third States nor their Governments can, according to the British and American view at any rate, object to their extradition thereunder"[19].

Nothing turns on *Lord McNair*. It is respectfully submitted that the Court erred in its reliance on Lord McNair for the following obvious reasons:

(i) Lord McNair had better articulated his view on the scope of a treaty at the outset of Chapter XVII itself in these clear words:

> "The British view appears to be, though it is difficult to assert that the question has ever been considered and answered as one of principle, that a treaty creates obligations between the contracting parties solely, that is, the contracting States (or, more popularly, their Governments), and not between one party and the nationals of another, or between the nationals of two or more parties; though, as we shall see, in practice it is often, and indeed usually, convenient to allow the assertion by or against individuals in municipal courts of rights or liabilities which their State has obtained for them or imposed upon them by treaty."[20]

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[19]. Lord McNair, *The Law of Treaties* (1961).

[20]. It is not necessary here to examine the question whether the rights which individuals may acquire under a treaty, and the duties which may be imposed upon them by a treaty, are rights and duties under international law or municipal law. There is nothing to prevent States from agreeing by treaty that their respective nationals shall be the subjects of rights and duties enforceable in municipal courts, or in tribunals such as the Mixed Arbitral Tribunals established by the peace treaties after the First World War. See p.336.

Lord McNair has stated the settled rule that the "effect of a treaty upon the contracting parties is that they only are bound by its provisions and must perform in good faith."[21]The effect of treaties upon third states and its nationals has been thus stated by Oppenheim, which gives the position as it stands under the current international law. Oppenheim states:

> "A treaty binds the contracting states only, and the Vienna Convention on the Law of Treaties 1969 reaffirms the general rule that a treaty does not create either obligations or rights for a third state without its consent: *pacta tertiis nec nocent nec prosunt*."

(ii) The import of Lord McNair's exposition, which the Bench quoted in the impugned judgment, has been explained in *Oppenheimn* thus[22]:

> "The binding force of a treaty and its effects concern in principle the contracting states only, and not their nationals. The rule can, as has been said by the Permanent Court of International Justice, be altered by express or implied terms of the treaty, when the provisions become self-executory (even, occasionally, as regards persons who are not nationals of the contracting state concerned)[23]. [Emphasis supplied]

In a footnote *Oppenheim* clearly refers specifically to Lord McNair's exposition in Ch. XVII of his Treaties.

(iii) Treaty Shopping was not even in the contemplation of Lord McNair when he wrote his treatise. It is worthwhile to see what sort of treaties he had in his mind when he made his observation in Chapter XVII of his book under the head "*The effects of a treaty upon the nationals of 'third state'*.

(a) The first treaty he discussed is a Treaty of Extradition. Under the principle of territoriality an alien has the *impact* of his presence in the territory of a state. His whole presence was there. On him the state exercised full jurisdiction, of course subject to certain rules of international law. This is the ground which justifies that "any individual, whether he is a national of the prosecuting state, or of the state which is required to extradite him, or a third state, may be extradited."[24] There is a good reason for the British opinion that a state has right to surrender an alien ' if the relevant treaty does not, expressly or by implication, exclude aliens from its scope'.

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21. Oppenheim, *International Law* 9th ed p.1249.
22. *International Law* 9th ed para 622 page 1253.
23. "… On the question of the effect of some treaties on nationals of states which are not parties to their treaties see generally Capitant, *Les Traites de droit prive dans leur application aux nationaux des tiersb etats* (1928); McNair, *Treaties* ch. 17.
24. Oppenheim p. 955.

(b) The second treaty to which Lord McNair refers (and that too by way of an example) relates to the taxability of gains which the professors earned in real terms by rendering real services with their real territorial presence and impact. He writes " if an Anglo-American Convention provided that professors on the staff of the universities of each country were exempt from taxation in respect of fees earned for lecturing in the other country, and any necessary changes in the tax laws were made, that privilege could be claimed by, or on behalf of, professors of those universities who were the nationals of 'third States'. In the case of the Professors entitlement to benefits was under a convention; and necessary changes in the tax laws had been made This treaty situation does not help the Treaty Shoppers:

(i) as they have no significant economic presence in the country of which resident they pretend to be through fraud and collusion;

(ii) as the treaty does not provide benefit for them in the same way as the Convention did for the professors;

(iii) as there is nothing to indicate in our statute that grant of any benefit to them was justified.

(iv) as the arrangement under the Convention was a good-faith arrangement causing no wrongful loss to anyone and no wrongful gain to anybody.

(iv) Lord McNair was not contemplating a tax treaty, which even in England is done in exercise of statutory powers under Section 778 of the British Income-tax Act. This is so as after the Bill of Rights all matters pertaining to taxation were taken away from the realm of prerogative. Even under the British law a tax treaty is exclusively a statutory act done as per the procedure prescribed in the Act. In the United States such a procedure was not devised as there the Senate gives a legislative approval to a treaty. Under the framework of Indo-Mauritius DTAC there is nothing to indicate that a third country beneficiary is entitled to take advantage of the terms of the treaty [by wearing a mask]. The preamble to the DTAC stresses that through it a bond of contractual obligations had been established for certain mutual benefit. If the view is taken that mere formality of incorporation is enough to confer entitlement there would be an absurd result that all other treaties would become redundant as third country residents, wearing mask, would sail across the ocean to poach into India's revenue, [or jet into our country tainted wealth rotated through multi-layered masks from one tax heaven to another till it finds a way to our country to finance even terrorist activities].

(v) A critical reading of Lord McNair's text quoted by the Supreme Court takes one to an entirely different conclusion. The expression "Provided that any necessary implementation by municipal law has been carried out" refers to the typical British practice, which we share. It means that a statute should specifically provide grant of benefits to the third States' nationals. Both the instances which Lord McNair illustrate specific statutory bequest. An Anglo-American Convention provided that professors on the staff of the universities of each country were exempt from taxation in respect of fees earned for lecturing in the other country; necessary changes in the tax laws were made. Power to extradite is integral to international sovereignty but can be modified by the statute. A " necessary implementation by municipal law" is the pre-condition. So far the Indo-Mauritius DTAC is concerned there is no legislative provision to deviate from its pure bilateral situation by conferring benefits analogous to the situation referred by Lord McNair in his text, or in *Glen v. Compania Cubana de Aviacion, S.S.* referred by him in the footnote 1. Section 90(2) of the Income-tax Act contemplates the implementation of a tax treaty framed within the parameters of Section 90(1).

(vi) As the counsel for the Union of India had placed a wrong gloss on what Lord McNair had said, this author thought it appropriate to obtain an opinion of an expert on what Lord McNair said in Chapter XVII of his book. The Opinion of Dr M.L. Upadhyaya, former Professor & Dean of the University Department of Law, Calcutta University would amply show that the Attorney General was incorrect in reading Lord McNair. The text of the opinion has been quoted in the Chapter on Treaty Shopping.

(vii) Lord McNair had no way to learn the parameters of the Double taxation avoidance agreements nor by the time he wrote his treatise the state practice as to such agreements had become standardized wherefrom norms could be derived. Referring to his comment that "there is nothing to prevent the nationals of 'third states', in the absence of any express or implied provision to the contrary, from claiming the rights, or becoming subject to the obligations, created by a treaty"[25] Phillip Baker has observed that this statement of law is now considered to be of doubtful authority for the interpretation of tax treaties, whatever the position at the time written.[26]

(viii) A bilateral tax agreement is founded on the determination of various tax issues between the two contracting parties. The contracting states can represent their own nationals who under the tax treaties are called resi-

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25. Lord McNair, *The Law of Treaties* (1961) p.336.

26. Phillip Baker, *Double Taxation Conventions* 3rd ed (2001) at pp. 1-2 to 1-2/1 (2005 Supplement.) referred by Brian Cleave in his article on "Judicial interpretation of Tax Treaties—Educating the Judges" *BCAJ* Vol 39 Part 2 May 2005.

dents of the contracting states. There is nothing in the terms of the agreements or the preparatory materials or any superseding act to suggest that there was any intention to cast benefit or burden on the nationals of other states. Besides, there is nothing to suggest that any third state ever consented to avail of the benefits under a bilateral tax agreement. The preamble and the stipulations are designed to operate in the province of bilateral concern. To allow the nationals of third states to avail of the benefit amounts to the impermissible modification of the terms of agreement. Besides, this approach goes counter to Art 31(1) of the *Vienna Convention on the Law of Treaties*: it says—

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

(ix) This author under the caption **"reductio ad absurdum"** in the Chapter on "Treaty Shopping" has shown the absurd effect of allowing all others to access the benefits under a bilateral tax treaty. If it happens it would give rise to some atrocious situation:

> "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."

Even if the conservative approach to interpretation be adopted, as was done by the British Court in *Commissioners of Inland Revenue v. Commerzbank AG*[27], the judicial approach is manifestly flawed as:

(a) *Absence of prohibition* can not mean *grant of permission* for availing of benefits by those not party to the bilateral treaty done only for mutual benefit;

(b) The Court should not have departed from the following principle to which *Broom* refers *Expressio unius est Exclusio Alterius* Co. Litt (The express mention of one thing implies the exclusion of another)[28]:

> "And, where parties have entered into engagement with express stipulations, it is manifestly not desirable to extend them by implications; the presumption is, that having expressed *some*, they have expressed *all* the conditions by which they intend to be bound under that instrument."

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[27]. (1990) 63 TC. 218.
[28]. at p. 443.

(c) On this view the Court would be adding a term to the tax treaty which cannot be done without an overriding justification to promote the cause of justice;

(d) Reference to the Article 24 in the Indo-U.S. treaty is misconceived because in the U.S.A. a treaty is the supreme law of the land as it is done under the U.S. Constitution after deliberations of the Senate.

(e) In the context of the Indo-Mauritius tax treaty there was absolutely no relevance to make reference to Art 24 of the Indo-U.S tax treaty. It was framed under the U.S pressure whose corporate *imperium* had to be placated as what the U.S wants that must be the law. By relying on Art 24 of the Indo-U.S tax treaty, it is felt; the Court foreclosed the question of its legal and constitutional validity under the Indian jural system. The Court, it is submitted, committed a fallacy in its analogical reasoning, the defect of which had been pointed out by Bacon in these words:

> "I found in my own nature a special adaptation for the contemplation of truth. For I had a mind at once versatile enough for that most important object----I mean the recognition of similitudes—and at the same time sufficiently steady and concentrated for the observation of subtle shades of difference. I possessed a passion for research , a power of suspending judgment with patience, of meditating with pleasure, of assenting with caution, of correcting false impressions with readiness and of arranging my thoughts with scrupulous pains. I had no hankering after novelty, no blind admiration for antiquity. Imposture in every shape I utterly detested. For all these reasons I considered that my nature and disposition had, as it were, a kind of kinship and connection with truth." [29]

The inference that the Division Bench has drawn from the absence of something like Art. 24 of the Indo-U.S. DTAC in the Indo-Mauritius DTAC is vitiated by a fundamental mistake caused by an assumption that if something is not prohibited it is, by way of inevitable inference, permitted. This sort of reasoning is not only patently erroneous under the rules of construction but is contrary to what the Court has done in the *H.P.C.L Case*[30].

The misunderstanding of what Lord McNair said in the text quoted in the Judgment led the Court to one more patent error in its legal reasoning when it observed:

> "It is true that an international treaty between States A & B is neither intended to confer benefits nor impose obligations on the residents of State C, but, here we are not concerned with this question at all. The question posed for our consideration is: If the residents of State C qualify for a benefit under the treaty, can they be denied

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[29]. Sir Francis Bacon, the Lord Chancellor of England 1618-21 quoted in Legouis & Cazamian, *A History of English Literature* p. 368.

[30].

the benefit on some theoretical ground that 'Treaty Shopping' is unethical and illegal? We find no support for this proposition in the passage cited from Oppenheim".

It is respectfully submitted that the core question was: whether a tax treaty between A and B would confer benefits or impose obligations on residents of State C. The real question gets quenched in the way the Court articulated the question for judicial consideration "If the residents of State C qualify for a benefit….". In fact a logical fallacy is at work, the fallacy of *post hoc, ergo propter hoc* ('after this therefore because of this.'). The assumption that the residents of State C qualify for benefits under a tax treaty is itself under question: and it is to be decided by the terms of a tax treaty in the context of the municipal law and Public International Law.

Our Supreme Court in *Azadi Bachao* states:

> "The respondents then relied on observations of Philip Baker (Philip Baker, Double Taxation Convention and International Law, page 91 (1994), second edition) regarding a seminar at the IFI Barcelona in 1991, wherein a paper was presented on "Limitation of treaty benefits for companies" (Treaty Shopping). He points out that the Committee on Fiscal Affairs of the OECD in its report styled as "Conduit Companies Report 1987" recognized that a conduit company would generally be able to claim treaty benefits".

The entire observation, it is submitted, is unsound in many ways: viz—

(a) The Court made a patent mistake in stating that it was articulating the stand of the respondents. Only the Appellants (the UoI & the Mauritian company) could advance this type of plea.

(b) The Court notes that it was considering some observations by Phillip Baker regarding a seminar at the IFI Barcelona in 1991, wherein a paper was presented on "Limitation of treaty benefits for companies" (Treaty Shopping). "Observation" means " a comment or remark that you make about something, especially as a result of having watched or thought it a lot." [Collins Co-build English Language Dictionary]. It is respectfully submitted that Phillip Baker made in his book, [*Double Taxation Conventions and International Law A Manual on the OECD Model Tax Conventions*] no *observation* of any sort. He merely noted in the footnote 53 at page 90 of his book: 'This topic was the subject matter of Seminar at the I.F.A. Barcelona Congress in 1991---see the Congress paper on "Limitation of Treaty Benefits for Companies Treaty Shopping."

(c) As the paper read at the Seminar at the I.F.A. Barcelona Congress in 1991 was never placed before this Court; the Division Bench of our Supreme Court erred in relying on it.

It is respectfully submitted that it was under serious mistake and miscomprehension that the Division Bench just before concluding this core issue of Treaty made a laconic observation:

> "He points out that the Committee on Fiscal Affairs of the OECD in its report styled as "Conduit Companies Report 1987" recognized that a conduit company would generally be able to claim treaty benefits".

The view of the Conduit Companies Report 1987 referred above goes counter to the settled principles of civilized jurisprudence to which the Statute of the International Court of Justice refers. 'Pacta *sunt servanda'* is founded on the Principle of Good Faith[31]. The Vienna Convention on the Law of Treaties in Art. 26 defines 'Pacta *sunt servanda'*.

> "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

The Court would have surely taken a different view if it had gone through the pages 93-94 of Phillip Baker's book. The 1992 Commentary refers to a general provision ensuring treaty benefits in *bona fide* cases. Phillip Baker in his book writes at p. 94, under the sub-heading "Domestic approaches to treaty abuse":

> "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 will depend upon the issue of priority between domestic law and international law…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."

The 1992 Commentary rightly said: "The Report concluded that the effectiveness of this domestic law attack will depend upon the issue of *priority between domestic law and international law*." As we follow the British practice, the right perspective would have been what is delineated by the Court of Appeal in *Trendex Trading Corporation Ltd v. Central Bank of Nigeria*[32]. The 1992 Commentary says: "The majority of countries in the OECD took the view that such approaches were applicable even without specific provisions." The referent is the domestic anti-avoidance provisions. If these experts, if they can be called 'experts', would have gone through the cases decided by the British Courts, the U.S. courts, the Hoge Raad of the Netherlands, the Bundesfinanzhof of Germany, the Federal Court of Switzerland they would have seen that judiciary always rejected their line of thinking. They were essentially lobbyists, not jurisconsults. If these so-called experts would have read the decisions[33] of our Court, they would have

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31. Georg Schwarzenberger, A Manual of International Law p. 148.
32. [1977] 1 All ER 881 CA.
33. *Shrisht Dhawan v. M/s Shaw Brothers*, AIR 1992 SC 1555 at pp. 1564-1565; *New Horizons Ltd. v. Union of India* [1995] 1 SCC 478; *State of UP v. Renusagar Power Company* [1988] 4 SCC 59; *CIT v. Sri Meenakshi Mills Ltd.,* AIR 1967 SC 819.

found that our judges belong to the same fraternity to which Lord Denning belongs: Denning who articulated a fundamental creed of judicial administration which this author would, after variating it to suit the present context, state thus: "No judgment of court, no order of a Minister, can be allowed to stand if it has been obtained by fraud. Fraud unravels everything."[34] The 1992 Commentary, Philip Baker writes, "also helpfully emphasizes that anti-avoidance measures must comply with the spirit and purpose of tax treaties to avoid double taxation." If through *domestic anti-avoidance* measures the "the spirit and purpose of tax treaties to avoid double taxation" is to be promoted then what survives of the view of the Conduit Companies Report 1987? Clearly Nothing. If only the Court would have seen the worthlessness of the view of the *Conduit Companies Report 1987,* if only this Court would have gone through those pages (pages 94-104) wherein Phillip Baker discusses the anti-avoidance approaches of the courts of various jurisdictions in the World, the judicial decision would have been different! This judicial overlooking led our Supreme Court to one more serious mistake. The Court observes:

> "True that several countries like the USA, Germany, Netherlands, Switzerland and United Kingdom have taken suitable steps, either by way of incorporation of appropriate provisions in the international conventions as to double taxation avoidance, or by domestic legislation, to ensure that the benefits of a treaty/convention are not available to residents of a third State."

This Court would have found on reading those pages of Philip Baker that it is the COURT of these countries, which applied anti-avoidance provisions of the domestic law. Whenever this sort of issue was before a court of law it decided against it. No court before the decision in *Azadi Bachao* judgment felt it prudent to pass the buck to the Executive or the Legislature.

But none of the errors stated above would have led the Court to uphold Treaty Shopping if the Court would not have relied on Roy Rohatgi's book. As this is a crucial point of greatest importance it is examined in a separate Chapter of the book; "Reading & Discrimination". The conclusion on this point is that the Court admitted a book in breach of the governing norms, and failed in weighing it before making it the forte of its judicial reasoning. The judicial act was so manifestly wrong that, it is respectfully submitted, it became without jurisdiction.

In short, and in fine, *Azadi Bachao* does not succeed in removing the 'shadow' that bedevils us by its presence between 'idea' and 'reality'. It is this shadow which turns a corporation into an impervious cover-let of gross abuse.

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34. *Lazarus Estates Limited v. Beasley*, [1956] 1 QB 702 at 712.