

SATURDAY INTERNATIONAL TAX GYAN !!!

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SITG No.
128



Treaty Shopping – A Brief discussion

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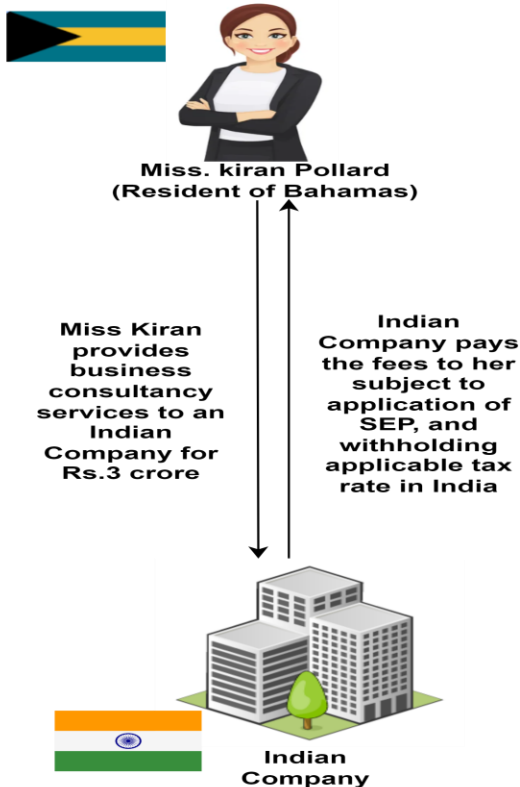
What is Treaty Shopping?

- ❖ **Treaty shopping** occurs when a person or an entity seeks to take advantage of a Tax Treaties(DTAA) between two Contracting State by establishing an entity in the State in which the entity seeking advantage is not a resident.
- ❖ In other words, Treaty Shopping or **Round Tripping** is an arrangement where a person resident of a third State attempts to take indirect benefits that the tax treaties is providing to the resident of the contracting state. The ultimate moto/intention behind it is to receive tax benefits.
- ❖ Such person taking indirect benefit of treaty is referred as **conduit**.
- ❖ **Supreme Court** in the case of **Union of India V. Azadi Bachao Andolan**{[2003] 132 Taxman 373 (SC)/[2003] 263 ITR 706 (SC)/[2003] 18...} defines treaty Shopping as 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.([Click here](#) to know more about this case)

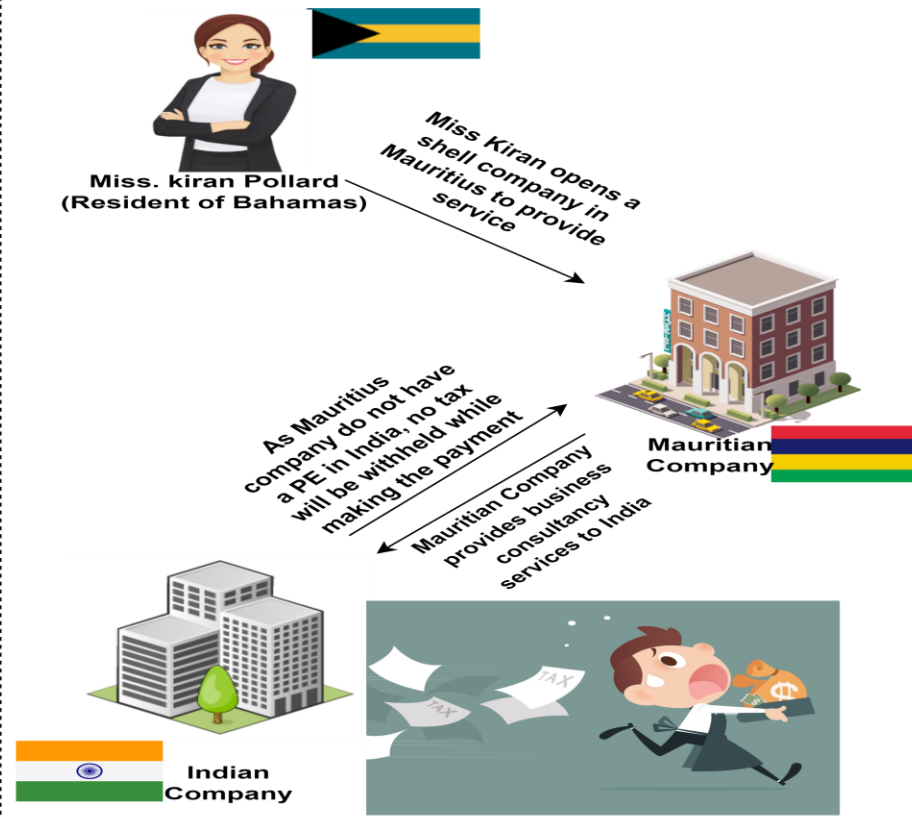
Treaty Shopping: Example

- ❖ Miss Kiran Pollard is the resident of Bahamas and intends do business with India. Nature of transaction is business consultancy service worth Rs.3 Crores. As per the Income tax act this might attract the provisions of **Significant Economic Presence(SEP)** ([Click here](#) to read about SEP). This would lead to taxability of such amount at the rate applicable as per the Indian Income Tax Act and since, there is no DTAA signed between both the countries, no tax relief is available.
- ❖ Thus, in order to save such huge amount of tax, Miss Kiran opens a shell company in Mauritius. Now, the invoice will be raised by the Mauritius company to the Indian company and as per the relevant article of the DTAA between India & Mauritius, such taxability would depend on the presence of PE(Permanent Establishment) in India.
- ❖ Now, Mauritius company will certify that it has No PE in India, accordingly the taxability will arise in source country i.e. Mauritius. Hence, no tax has been charged on such amount in India just by opening a company in Mauritius where Miss Kiran is actually not a resident and this is known as treaty shopping.

Situation 1- No Treaty Shopping



Situation 2- Treaty Shopping



Here, Since the DTAA is not signed between the contracting states, Benefit of No PE cannot be claimed and thus tax needs to be paid by Kiran in India at applicable rates

Here, Since the DTAA is available between the countries, its benefit can be easily availed to save taxes. Since the mauritius company is not having PE in India & thus as per DTAA between both countries such service will not be taxed in India.

Our Comments

In order to prevent such arrangements to happen, various countries and OECD members have come up with a lot of anti-treaty shopping regulations. Some of which are as under-

- ❖ The OECD countries have come up with the **Base Erosion Profit shifting (BEPS) action plans (Action-6)**. Action 6 identifies tax policy considerations jurisdictions should address before deciding to enter into a tax agreement.
- ❖ Tax heaven countries like UAE, etc. have brought the concept of **Principal Purpose Test**, under which entities have to **justify their presence** in the country they are incorporated in.
- ❖ Concept of **LOB (Limitation of benefit) clause** has been introduced in various DTAA entered into by India with various countries. Under this entities have to satisfy the condition of '**beneficial ownership**'. (Full details of this clause will be discussed in the upcoming SITGs.)
- ❖ Further, various courts have also started to lift the corporate veil in order to check whether the entity can actually avail such treaty benefit or not. **Tiger Global International II Holdings** {[2020] 116 taxmann.com 878 (AAR - New Delhi)/[2020] 429 ITR 288 (AAR – New Delhi)[26-03-2020]}([Click Here](#) to know more about this case)

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