

**TAX TREATY OVERRIDE: A COMPREHENSIVE ANALYSIS WITH SPECIAL
REFERENCE TO INDIA**

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I. INTRODUCTION

Taxation norms can be dated back several centuries with the earliest record being that of ancient Egypt in 1580 B.C.¹ Aristotle makes a mention that income tax was levied by King Tachus in Egypt upon all employments.² The purpose of taxation according to the Romans under the Code Theodosius (I. XIII tit. i. iv.) was:

*“With the view of sharing that species of wealth which is derived from art and labour and which exists in money and merchandise, the emperors imposed a distinct and personal tribute on the trading part of their subjects.”*³

Even today the duty of the sovereign is to collect business and trade income tax from his citizens. Given that the world is comprised of a number of ‘sovereign’, independent states which do not have homogeneous economic systems, every one of them, in the exercise of its supreme power and in light of its own political-cum-socio economic ‘philosophy’ and its financial needs, devises and fashion its own tax system applicable to persons, events or things within its jurisdiction.⁴

¹ Charles R. Metzger, *A brief History of Income Taxation*, 13 A.B.A. J. 662 (1927), see also Breasted, *Ancient Records*, Vol. 2, par. 706.

² *Ibid*, p. 662

³ *Ibid*.

⁴ IP Gupta, *International Law in Relation to Double Taxation of Income with Particular reference to India* (Lexis Nexis Butterworths, 2007) P. 5

With the age of globalisation and cross border interaction of trade economies taxation is not as simple as it was. The attitude of ‘me, myself and I’ can no longer sustain in a world economy. Thus, arising the need of tax treaties, tax treaties in comparison with domestic tax laws, help fulfil to a greater extent some of the classic tenets of a sound tax system, namely stability, certainty, and uniformity. It is this feature which has a great impact in building up a more suitable climate for flow of capital, investment, technology and personnel from one country to another. Eventually, the sincerity of the business community about long term tax policies leads an international entrepreneur to decide whether to start or continue investing in a particular country or not.

On the other hand however, the frequent change in the domestic tax laws through retrospective amendments known General Anti Avoidance Rule (GAAR) have gravely impacted tax treaties. Such domestic amendments have generated a wave of scepticism among many international business investors. In this paper the authors have made an attempt to see whether tax treaties are being overridden by the nations in the true sense of the term via domestic amendments, or whether is it a mere fear of outside intervention?

This paper is divided into four sections; Part II discusses the basic concepts pertaining to formulation, enforcement and regulation of tax treaties at the international level. Part III deals with “Tax Treaty Overrides” as contemplated by the Vienna Convention on Law of Treaties and OECD Commentaries and Reports. This section specifically focuses on two events of treaty override; first, when there is “material breach” of treaty by the Contracting States. Second; the extent to which domestic law can override a tax treaty.

Further, in Part IV the authors have dealt with the Indian position on Tax Treaty Overrides. Herein we analyse the effect of retrospective amendments made to the domestic income tax law on international tax treaties. Apart from this, the authors have also discussed the effect of

GAAR on tax treaties with special reference to the India-Mauritius Double Taxation Avoidance Agreement (DTAA). In addition, the authors have dealt with limitation on benefit clause in India-Singapore DTAA. Also, the recommendations put forward by the Shome Committee with respect to GAAR's and Tax Treaty Override has been criticized. In addition, the authors in the paper have made an attempt to justify India's actions under section 94A of the Income Tax Act, 1961 with respect to India-Cyprus Tax Treaty. Conclusive to these incidences the authors have tried to find solutions to deal with contracting states and treaty override.

II. THE TENETS OF INTERNATIONAL TAX TREATIES

International cooperation is one of the most important means to protect individual states and their taxpaying citizens from the inequities in the issues referred to above, primarily double taxation and tax evasion. This multinational approach began in the 1920's with the League of Nations, which drafted the first model tax convention in 1928 for use by member countries.⁵ Though the League of Nations dissolved in 1946, but the responsibility of tax cooperation was picked up by the Organization for European Economic Co-operation (OEEC), a body of seventeen European nations administering plans for reconstruction after World War II.⁶ In 1961, the OEEC merged into an international body of developed nations, the Organization for Economic Co-operation and Development (OECD), founded by the original European countries, the United States, Canada, and thereafter, other modern industrial nations. It also served as the basis of the original drafting of the complimentary United Nations model.⁷ The United Nations Model Double Taxation is another international instrument that try to harmonise double taxation between countries in bringing about DTAA's. It has been highly

⁵ Han Sung-Soo, *The Harmonisation of Tax Treaties and Domestic Law*, 7 Int'l L. & Mgmt. Rev. 30 (2011)

⁶ Ibid.

⁷ U.N. Dep't of Econ. & Soc. Affairs, United Nations Model Double Taxation Convention between Developed and Developing Countries, at vi, U.N. Doc. ST/ESA/PAD/SER.E/21 (2001), available at: <http://www.un.org/Docs/journal/asp/ws.asp?m-ST/ESA/PAD/SER.E/21>.

influential in negotiation and implementation of bilateral tax treaties both developing and developed countries.⁸

The OECD however cannot operate in isolation in an international system, it serves as a guideline with respect to cross border taxation read with the Vienna Convention on the Law of Treaties, 1969 (VCLT). According to the Statute of International Court of Justice “International conventions whether general or particular, establishing rules expressly recognised by contesting states” is one of the sources of Public International Law.⁹ Public international Law governs the relation between States and determines their mutual rights and obligations. Prior to 1969, treaties were mostly governed by the customary rules of International law. The need for certainty and clarity led the International Law Commission to formulation of VCLT which is now ‘recognized as authoritative guide to current treaty law and practice’¹⁰. It defines under Article 2.1 (a) that:

“treaty” means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation”¹¹

Thus, a treaty is an agreement between sovereign nations. Further, negotiated treaties frequently contain additional supporting data that form an integral part of a treaty, such as a protocol, exchange of letters, or memorandum of understanding.¹² The exchange of letters clarifies the treaty provisions and forms part of the treaty.¹³ In the same way, Tax Treaty is an

⁸ Michael Lennard & Martin Borrensen, *The Revised United Nations Model Double Taxation Convention*, INT’L TAXATION, (June 2012), p 769

⁹ Art. 38 (1) (a), Statute of the International Court of Justice

¹⁰ Starke’s International Law Eleventh ed. (2001) p. 397

¹¹ Article 2.1(a) Vienna Convention on Law of Treaties

¹² Roy Rohatgi, *Basic International Taxation*, 2nd ed. Vol 1. (Taxmann, 2005) p. 17. [Hereinafter Roy Rohatgi]

¹³ Ibid.

international agreement between sovereign nations which legally binds the states participating to act in a particular way or to set up particular relations within themselves.¹⁴

Taking a brief look into taxation laws; differing applicability of taxing statutes by various countries and use of altering bases for calculating taxes has complicated the global economy and accountability to pay taxes. As there is little global tax harmonisation, domestic tax systems often conflict on cross-border transactions and lead to excessive taxation.¹⁵ The other dilemma would be double taxation which is generally accepted as an impediment to international investment and trade, many countries provide unilateral relief to avoid or minimise double taxation under their domestic laws. This relief could be a tax exemption or a tax credit or, as a minimum, an expense deduction for the foreign taxes paid. However, double taxation could still arise as a result of a difference of opinion between countries on basic taxing principles and taxing rights.¹⁶ Therefore, domestic measures may be useful but are insufficient and inflexible in nature.¹⁷

To address cross border tax conflicts international tax treaties are put into place which follows the principles of international law and adhere to the VCLT for interpretation. For example juridical double taxation conflicts are largely resolved through tax treaties negotiated under the principles of international tax law accepted by sovereign states.¹⁸ The other perk of tax treaties is that it also protects taxpayers from unfair tax discrimination on cross border trade and investments. Moreover, they try to curb international tax evasion through a mutual exchange of information on tax matters between the national revenue authorities.

¹⁴ Malcolm N. Shaw, *International Law*, 5th ed. (Cambridge University Press 2007) p.88.

¹⁵ Roy Rohatgi, p. 16.

¹⁶ *Ibid* at 17.

¹⁷ *Ibid* at 2.

¹⁸ *Ibid* at 16.

III. INTERNATIONAL POSITION ON TREATY OVERRIDE

One of the main problems of having dual laws i.e. international laws and domestic laws is that conflicts may occur between the two causing treaty override which maybe intentional or unintentional. Intentional treaty overrides include situations such as; later law overrides prior law or superior treaties¹⁹ supersede tax treaties. Overrides that are not intended may arise in situations like; a Court decision may be contrary to common interpretation of the treaty partners. Such legal decisions could amount to a treaty override. However, the State has legislative power to reverse the effect, and the reversing legislation in consultation with treaty partner would be an acceptable remedy. Another example of unintentional treaty is reflected in a situation where a State may redefine an undefined treaty term under its domestic law, which effectively overrides a treaty. Such changes in domestic law are permitted only when they are compatible with the context of the treaty and accepted by the other Contracting State. Often such unilateral changes are made unjustifiably by states to combat treaty abuse. The correct remedy would be to renegotiate the treaty.²⁰

A. THEORETICAL ASPECT OF TREATY OVERRIDE

In order to handle the issue of conflict in laws a common customary international law is applied to ease transaction and treaty interpretation. As such the VCLT provisions are adhered to, wherein every treaty in force is binding upon contracting parties and must be performed by them in good faith or *Pacta Sunta Servanda*.²¹ This principle of good faith is also mentioned in the VCLT preamble where it states that “principles of free consent and of good faith and the *pacta sunt servanda* are universally recognized.” However, there is no further explanation in the VCLT of what good faith means. A United Nations report in 2001, mentions that “good faith requires fairness, reasonableness, integrity and honesty in

¹⁹ Diplomatic treaties for example are treated as superior treaties.

²⁰ Klaus Vogel, Double Taxation Conventions, Introduction. 131-132.

²¹ Article 26 of VCLT

international behaviour.”²² Since it essentially codifies the existing norms of customary international law on treaties, it is also considered to be binding on non-signatories and applicable to both past and future treaties. The rules of VCLT apply to all international treaties, including tax treaties.

The VCLT is rather extensive; it clearly casts a duty on the parties to the convention not to defeat the purpose of the treaty under Article 18. In addition, the interpretation of such treaties will be done in good faith as enshrined under Article 31. It also provides that; a State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.²³ A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.²⁴ Thus, a country once entered into a convention cannot take the excuse that internal law is inconsistent with the treaty defeating its purpose altogether.

a) MATERIAL BREACH OF CONTRACT

Under the VCLT a breach of a treaty occurs when there is material breach, only then will international remedies be available. In the words of Article 60 of the VCLT, a material breach requires an unsanctioned repudiation of the treaty or “the violation of a provision essential to the accomplishment of the object or purpose of the treaty.” In the law of treaties the principle according to which an omission is dealt with, as a rule in bilateral relations, is reflected in Article 60 paragraph 1 of the VCLT and in paragraph 2(b) of the same Article it is stated that; “a *material breach of a multilateral treaty by one of the parties entitles: b) a*

²² Roy Rohtagi p. 33

²³ Article 46, VCLT

²⁴ Ibid

party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part, in the relations between itself and the defaulting state.”²⁵

This provision articulates that an omission or change in the domestic law in whole or in part affecting the object of a treaty is thus a violation of Article 60. Such violations are especially seen in case of retrospective amendments done without the consent of contracting states; thus classifying it as a default to the treaty.

Further, the OECD Treaty Override Report²⁶ then gives two examples of treaty overrides. Example 1 is a straightforward case of a material breach of the treaty, in which a state introduces a new withholding tax on interest or royalties when these should be exempt from source-based taxation under the treaty. The OECD report states that “the breach being a material one, the treaty partners of State A would be justified in terminating their tax treaty relationship with State A. However, termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future.”²⁷ It is hard to find an actual example on which this scenario is based.

b) DOMESTIC LEGISLATION VIS-A-VIS TAX TREATY

Countries either follow a monistic or a dualistic approach while applying the international law of treaties. Those that follow a monistic principle link the treaty created to the municipal law and subordinate it to international law known as the “doctrine of incorporation.”²⁸ Countries like Japan, Netherlands, Portugal and Spain follow this approach. However; in the dualistic approach the country distinguishes the two as separate law, this

²⁵ Article 60, par. 2(b)

²⁶ Committee on Fiscal Affairs: Tax Treaty Override, para 2 (OECD, 1989)

²⁷ OECD Report Para 3

²⁸ Roy Rohtagi, at 17.

requires specific domestic legislation under the “doctrine of transformation.”²⁹ USA, India and Australia follow the dualistic approach in incorporating treaty law to their domestic laws.

Treaties usually, but not always, have priority over domestic law.³⁰ Therefore, as treaties remain unchanged for a period (average fifteen years) and take time to renegotiate, they provide certainty and protection against adverse changes in domestic tax laws.³¹

Art. 27 of Vienna Convention on the Law of Treaties enunciate that “*a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.*” Thus, it is clear that treaty overrides constitute a violation of international law. That is to say, domestic law cannot serve as a justification for the non-compliance with treaty obligations. In general, tax treaties override existing domestic laws and are even given precedence over subsequent domestic laws. However, several countries allow treaty overrides if a subsequent legislative act either is specifically intended to override or provides for a clear statutory provision that cannot be reconciled with the treaty.³²

The OECD Report defines treaty override as “domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.”³³ The Report then clarifies that such treaty overrides clearly violate international law (citing the VCLT), although they may still be binding as a matter of domestic law.³⁴ To explain this situation, the Report gives Example 2 which is more realistic in nature. The example says that, State B taxes capital gains from the sale of real property, but under its tax treaties is precluded from taxing capital gains on sales of stock. Taxpayers interpose a State B corporation between themselves and the real property and sell the shares in the corporation instead. State B

²⁹ Roy Rohtagi, at 17.

³⁰ Roy Rohatgi p.33

³¹ Roy Rohatgi p.33

³² Sol Picciotto, International Business Taxation, p.311.

³³ Committee on Fiscal Affairs: Tax Treaty Override, para 2 (OECD, 1989)

³⁴ OECD Report p.29

legislates that the sale of the stock is deemed to be a sale of the real property for purposes of its treaties.³⁵

This example is clearly based on the Foreign Investors in Real Property Tax Act of 1980 (FIRPTA), which constituted a treaty override and provides that sales of shares in “US Real Property Holding Corporations” be subject to tax, even when a treaty prevents taxation of capital gains at source.³⁶ The OECD Report condemns the treaty override, stating that “the effect of such legislation is in contravention of State B’s tax treaty obligations, even though the overriding measure is clearly designed to put an end to the improper use of its tax treaties. There may be cases where State B could successfully argue that there is such an improper use and deny the treaty benefits but this must be done under the existing rules.”³⁷

The 1989 OECD Treaty Override Report discouraged unilateral overriding legislation to counter treaty conflicts. It suggested that in situations where conflict of provisions was inevitable, the treaties should be renegotiated.³⁸ However, the subsequent OECD Commentary on “Improper Use of the Convention” in 2003 supports the view that these anti abuse rules under domestic law do not have to be specifically included in tax treaties to be effective.³⁹ It argues that taxes are ultimately imposed through domestic law provisions, as restricted by the tax treaties. Thus a treaty abuse is essentially an abuse of the domestic law under which the tax is levied. To the extent, anti avoidance rules are a part of the basic domestic taxation; these rules “are not addressed in tax treaties and therefore not affected by them”. It concludes that “a proper construction of tax conventions allows them to disregard abusive transactions” involving unintended treaty benefits. Therefore, “States do not have to

³⁵ OECD Report p.31

³⁶ IRC Section 897

³⁷ OECD Report 31

³⁸ OECD 1989 Report Annex A.

³⁹ OECD Commentary: Article 1, Para 7-26

grant benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into”.⁴⁰

B. MAJOR INSTANCES OF TAX TREATIES OVERRIDE AROUND THE GLOBE

Tax Treaty override is not an isolated phenomenon only faced by developing countries like India and China, however it is also common in developed countries such as the United States of America, Germany and Australia to name a few. In this respect the authors will be analysing recent instances of tax treaty override in both developed and developing nations via retrospective amendments made to the same.

i. US CANADIAN TAX TREATY AND FATCA

Under Article VI.1 of the US Constitution “treaties made or which shall be made under the authority of the United States, shall be the supreme law of the land and the Judges in every state shall be bound thereby.”⁴¹ Thus, the United States follow the doctrine of incorporation where a tax treaty is self-executing and requires no further legislation except if it is inconsistent with the Constitution. As per the International Revenue Code many U.S citizens, wherever in the world they reside or earn their income are subject to having taxes levied on their income.⁴² According to section 7852 (d) (1) of the IRC a treaty is a part of legislation enforceable by US Courts and has an equal status with other federal clause. In case of divergence between treaty law and domestic law as held in *Whitney v. Robertson*⁴³ the Courts and tax authorities are bound to apply *lex posterior derogate legi priori* i.e. the latter bounds prior law. Yet; the US Congress has also made provisions that treaty override is permissible otherwise foreign countries would be able to sanction changes via international treaties into US domestic laws. For instance the Foreign Investment in Real Property Tax Act of 1980 has

⁴⁰ OECD Commentary Article 1 Para 9.2-9.4.

⁴¹ Article. VI.1, The United States of America Constitution

⁴² 26 International Revenue Code § 911 (2013). [Hereinafter IRC Code]

⁴³ *Whitney v. Robertson* (1988) 124 US 188, 190

made available provisions for treaty override. Thus, treaty override is discretionary wherein *Cooke v United States*⁴⁴ the US Supreme Court held that the intent of the Congress to override a treaty must be clearly expressed.

However, there has been much controversy surrounding the recent US legislation on Foreign Account Tax Compliance Act (FATCA) which became law in March 2010.⁴⁵ Earlier the US had signed a treaty with Canada in 1980 on income and capital taxation with the latest protocol amendment on 2007.⁴⁶ This is a form of anti avoidance measure whereby the Canadian Government has agreed to supply information and allow the US Government to track down tax evaders. Though well intended; most practitioners see the FATCA as a tax treaty override. In a recent article Allison Christians says that FATCA overrides the existing tax treaty by significantly limiting a material benefit.⁴⁷

It is not uncommon to see provisions in tax treaties which provide “exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes to which this Convention applies insofar as the taxation thereunder is not contrary to this Convention.”⁴⁸ However, the US’ manoeuvre to legislate the FATCA in making additional provisions with respect to the taxation treaty in its favour goes against treaty *pacta sunt servanda*.

⁴⁴ *Cooke v. United States* (1933) 288 US 102

⁴⁵ Foreign Account Tax Compliance Act, Internal Revenue Service, *available at*: [http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-\(FATCA\)](http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-(FATCA)). (last visited Feb. 26, 2014)

⁴⁶ Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, Department of Finance Canada, *available at*: <http://www.fin.gc.ca/treaties-conventions/unitedstates-etatunis-eng.asp> (last visited Feb. 28, 2014)

⁴⁷ Allison Christians, *Why FATCA Is A Tax Treaty Override*, LexisNexis Legal Newsroom Tax Law, *available at*: <http://www.lexisnexis.com/legalnewsroom/tax-law/b/fatcacentral/archive/2013/01/21/why-fatca-is-a-tax-treaty-override.aspx> (Last visited Feb. 26, 2014)

⁴⁸ Article 27 of the US-Canada Tax Treaty

Under FATCA, in order for resident Canadian institutions to continue to get the treaty rate they must fulfil FATCA information gathering and reporting requirements.⁴⁹ If they do not confirm with these requirements, they will not be eligible for the treaty rate, but rather they will be subject to a 30% withholding rate on all “withholdable payments”.⁵⁰ This method of exclusion from treaty rate is nowhere mentioned in the US-Canada treaty it is solely a US instrument of gaining extra benefit of taxation rate. Such provisions implicate that the US disregards the bilateral treaty with Canada which is therefore; unilaterally denying Canadian citizens of treaty rate is a treaty override. In case such material overrides were to occur the US-Canada Treaty provides “where domestic legislation enacted by a Contracting State unilaterally removes or significantly limits any material benefit otherwise provided by the Convention, the appropriate authorities shall promptly consult for the purpose of considering an appropriate change to the Convention.”⁵¹

ii. UNITED KINGDOM’S RETROSPECTIVE TAXATION

In the late 2000’s there have been much debate over taxation legislations in the UK, specifically Section 58 of the Finance Act 2008 which is seen as retrospective in its effect. At the time the Labour Government took the view that the legislation clarified existing legislation which had been introduced in 1987, and that it was a reasonable response to the operation of an abusive tax avoidance scheme.⁵² Many argued that such changes gave way to an unfairly retrospective legislation.

In 2011 the Court of Appeal considered a legal challenge to overturn this provision on the grounds that it was incompatible with the European Convention on Human Rights, though the

⁴⁹ Ibid

⁵⁰ Ibid

⁵¹ Article 29(7) of the US-Canada Treaty

⁵² Antony Seely, *Retrospective taxation : section 58 of the Finance Act 2008*, Standard Note: SN6361, House of Commons Library(Aug. 28, 2013)available at: <file:///C:/Users/Hp%20Laptop/Downloads/SN06361.pdf> (last visited March 1, 2014)

Court ruled that “the legislation achieves a fair balance between the interests of the general body of taxpayers and the right of the Claimant to enjoyment of his possessions, without imposing an unreasonable economic burden on him.”⁵³ The British Government claimed that section 58(4) was merely clarificatory of an existing piece of retrospective legislation Clause 62(2) of the Finance Act 1987, known as ‘Padmore’.⁵⁴ Padmore retrospectively closed a loophole that meant UK residents could not be taxed on their share of any profits from a foreign partnership.⁵⁵

In the late 18th century economist Adam Smith, proposed that, “the tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.”⁵⁶ Section 58 states that “UK residents are taxable on their income wherever it arises”. Due to the amendment under Section 58 many workers across the U.K working abroad face back taxes that can go back as far as 1987 and retrospectively apply tax legislation for those using offshore schemes as a way of avoiding paying UK taxes.⁵⁷ Thus, such a change overturns Smith’s principle of certainty and it also goes against the international principles of taxation.⁵⁸

iii. GERMANY AND THE UNCONSTITUTIONALITY OF TREATY OVERRIDE

Germany signed the VCLT in 1970 and later ratified it on the 20th August, 1987⁵⁹ thus; treaties are interpreted in the light and purpose of the VCLT. Germany has quite an upright

⁵³ Ibid, see, R v Her Majesty's Revenue and Customs [2011] EWCA Civil 893 par. 95

⁵⁴ About Section 58, No To Retrospective Taxation, *available at*: <http://notoretrotax.org.uk/about-section-58/>

⁵⁵ Ibid.

⁵⁶ “Morality, tax avoidance and retrospection”, Tax Journal, 2 March 20(2)

⁵⁷ BN66 / Section 58 / Contractor Offshore Schemes, Contractor UK, *available at*: <http://www.contractoruk.com/bn66/>

⁵⁸ The Granting of Treaty Benefits with Respect to the Income of Collective Investments Vehicles, Adopted by the OECD Committee on Fiscal Affairs (Apr. 23,2010) p. 7, *available at*: <http://www.oecd.org/tax/treaties/45359261.pdf>

⁵⁹ Dr. Christian Levedag, *Interpretation of Tax Treaties: The use of the Vienna Convention*, IATJ 3rd Assembly in Munich, Germany (October 18, 2012) *available at*:

view with treaty overrides, starting with Klaus Vogel Germany's celebrated taxation expert who highly criticized such an action. Klaus pointed out that treaty override the domestic law that is effective at the time of their implementation.⁶⁰ He added that, the supplementary rule that later general legislation does not overrule earlier special legislation does not automatically affect existing treaties.⁶¹ Only when general law is expressly or implicitly intended to repeal the special law does a general law overrule special legislation.⁶²

In a recent Court decision marked (BFH 11 December 2013, I R 4/13); the German Federal Fiscal Court (BFH) held that the treaty override by domestic German tax legislation was unconstitutional.⁶³ As per the facts of the case, a German limited partnership (GmbH & Co. KG – “KG”) paid interest to an Italian resident who also owned an interest in the KG itself. Citing a 2008/2009 amendment of the German Income Tax Act (Section 50d (10) ITA), the German tax authorities reclassified the interest income as German business income of the partnership and claimed German taxation of the interest under the business income Article 7 (1) and the permanent establishment Article 5 of the German/Italian tax treaty (the Treaty), thus consequently denying Italy the right to tax the interest pursuant the interest Article 11 (1) of the Treaty.⁶⁴

Pursuant to Section 15 (1) No. 2 ITA, interest paid to a partner of a German business partnership is re-characterized as business income and taxed accordingly in the hands of the partner. Section 50d (10) ITA 2009 upholds this principle also in the treaty context by

<http://www.iaj.net/congresses/documents/InterpretationofTaxTreaties-Germany.pdf> (Last visited March 1, 2014)

⁶⁰ Wolfgang Kessler & Rolf Eicke, *German Treaty Overrides: Contractual Duties Meets Fiscal Interests*, Tax Notes International (Oct. 4, 2010) available at: http://steuerlehre-freiburg.de/fileadmin/repository/lehrstuhl/intltaxnotes/60TI0041-Kessler_Eicke.pdf

⁶¹ *Ibid* at p.42

⁶² *Ibid*.

⁶³ *German Federal Fiscal Court holds treaty override unconstitutional*, Ernst & Young Global Limited. (Feb. 19, 2014) available at:

[http://www.ey.com/Publication/vwLUAssets/German_Federal_Fiscal_Court_holds_treaty_override_unconstitutional/\\$FILE/2014G_CM4185_German%20Federal%20Fiscal%20Court%20holds%20treaty%20override%20unconstitutional.pdf](http://www.ey.com/Publication/vwLUAssets/German_Federal_Fiscal_Court_holds_treaty_override_unconstitutional/$FILE/2014G_CM4185_German%20Federal%20Fiscal%20Court%20holds%20treaty%20override%20unconstitutional.pdf)

⁶⁴ *Ibid*

defining such income as business income for purposes of the application of a tax treaty. Section 50d (10) ITA 2009 was introduced to override prior case law of the BFH which held that interest paid to a treaty resident partner cannot be taxed in Germany because of the interest article of the treaty. The statute is applicable with retroactive force on all open cases.⁶⁵

In its decision the BFH argues that this unilateral reclassification of remunerations which generally fall under a specialty article of a treaty as estimate business profits is indeed an override of those provisions.⁶⁶ In the opinion of the BFH, overriding bilateral treaty provisions that have been negotiated between two contracting states to allocate the right to tax constitutes an unconstitutional breach of international law.⁶⁷

iv. AUSTRALIA AND TREATY OVERRIDE

Australia enacted legislation in 1995 amending section 4(2) of the International Tax Agreements Act, 1953 to provide that its general anti-avoidance provisions take precedence over treaty provisions.⁶⁸ The effect makes these amendments clear that the GAAR provisions will override treaty provisions.⁶⁹

The 1981 GAAR is presently viewed by many stakeholders as one of the most mature and comprehensive in the world since its beginnings in 1915. The current GAAR was originally designed to replace what had been perceived as ineffective anti-avoidance laws. Australia's then-Treasurer John Howard stated that the 1981 rules were designed to strike down transactions believed to be "blatant, artificial and contrived." Over the years, the Australian

⁶⁵ Ibid.

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ Craig Elliffe & John Prebble, *General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective*, Revenue L. J. 19(2009)

⁶⁹ Ibid.

courts have expanded the GAAR's scope and reach to apply to what many view as normal, commercial transactions.⁷⁰

Most recently the Australian Government in March 2012 announced plans to amend the existing GAAR, 1981 of Part IVA. The Australian Taxation Office (ATO) has lost seven out of nine Part IVA cases in the last three years, resulting in a call for an overhaul of the provisions. On 16 November 2012, Australia's Assistant Treasurer released for public comment the exposure draft legislation (ED) and explanatory materials (EM) for the changes to Australia's GAAR (Part IVA) announced on 1 March 2012. The ED is intended to deal with perceived deficiencies in the operation of Section 177C of Part IVA (Income Tax Assessment Act 1936), which deals with the issue of "tax benefit." The EM states that the proposed amendments "are not intended to disturb the operation of Part IVA in any other respect."⁷¹

Australia's GAAR was originally directed toward arrangements that were regarded as "blatant, artificial or contrived." Today, the ATO regularly seeks to apply it more broadly, and legislative changes to widen the regime have been announced. Such experience demonstrates that, even when such rules are initially intended to have limited application, in practice, the extent to which tax authorities seek to apply them may stretch over time, a process known as "administrative creep."⁷²

⁷⁰ GAAR Rising Mapping tax enforcement's evolution, Ernst & Young, p. 7(February 2013), *available at*: [http://www.ey.com/Publication/vwLUAssets/GAA_rising/\\$FILE/GAAR_rising_1%20Feb_2013.pdf](http://www.ey.com/Publication/vwLUAssets/GAA_rising/$FILE/GAAR_rising_1%20Feb_2013.pdf)

⁷¹ Ibid.

⁷² Ibid.

IV. INDIAN POSITION ON TREATY OVERRIDE

A. TAX TREATIES IN INDIAN LEGAL SYSTEM

Article 246(1) of the Constitution of India, 1950 confers exclusive power on the Parliament to make laws with respect of any of the matters enumerated in List I Schedule VII. Entry 14 of List I refer to *entering into treaties and agreements* with foreign countries and implementation of treaties and agreements with foreign countries. Since the conclusion of treaties finds place in the Union List,⁷³ which deals with matters falling within the exclusive legislative competence of the Parliament, the constituent states have no role to play in the treaty-making process. The Parliament has the exclusive power to enact laws for ‘implementing’ any treaty under Article 253 of the Indian Constitution.

There is a clear distinction between the treaty making power and the treaty enforcement power. The former is purely an executive prerogative, and Parliament cannot enter into a treaty. Treaty enforcement power on the other hand vests fully in the Parliament. If the Parliament does not approve a treaty entered into by the executive by an act or resolution, the treaty though valid in international law, will not have the force of municipal law if treaty obligations entail alteration of existing law. In other words, in the Indian legal system, treaties do not take legal effect automatically, but are implemented indirectly through transforming legislations.⁷⁴

The Central government acts, in all matters (including treaty-making), through the President of India,⁷⁵ who may exercise those powers either himself or may delegate it to officers subordinate to him.⁷⁶ Treaties, in practice, are negotiated by the plenipotentiaries appointed by or on behalf of the President of India. Tax treaties are, in most cases, negotiated by

⁷³ Seventh Schedule of the Constitution of India 1950

⁷⁴ Jolly Verghese v. Bank of Cochin, AIR 1980 SC 470; State of West Bengal v. Kesoram Industries Ltd, AIR 2005 SC 1644; Gramophone Company of India Ltd. v. Birendra Bahadur Pandey AIR 1984 SC 66; State of Madras v. G.G. Menon AIR 1954 SC 517.

⁷⁵ See Arts 52 and 53 of the Constitution of India 1950

⁷⁶ See Art. 53 of the Constitution of India 1950

revenue officers of a certain rank in the Department of Revenue of the Ministry of Finance. The President, on the aid and advice of the Council of Ministers, ratifies the treaties.⁷⁷

Section 90(1) of the Income-tax Act, 1961 empowers the Central Government to bring tax treaties into force by means of a Government notification published in the Official Gazette. This provision gives *ex ante* legislative authorization to the Central Government to implement tax treaties entered into by it and is, therefore, in essence and substance, akin to legislative enactment.

In general, in case of a conflict between a domestic legislation and a treaty, the terms of the former alone are capable of implementation. Treaty provisions can be invoked and applied by domestic courts only either where there is no domestic statute on the point or to supplement (but not to contradict) a domestic law rule. However, with regard to the provisions of tax treaties, again, there is a departure from this general conflicts rule inasmuch as section 90(2) of the Income-tax Act, 1961 codifies the ‘more beneficial’ conflicts rule. In other words, ‘in its application to a taxpayer, a section 90 treaty is accorded a preferential status over the (domestic tax statute) and in case of a conflict between the treaty and the (domestic tax statute) it is the more beneficial of the two that prevails’.⁷⁸ To the contrary, in Netherlands, a treaty has priority over domestic law even if it is less beneficial.⁷⁹

B. RETROSPECTIVE AMENDMENTS

Retrospective amendment of Statutes by the Legislature is permissible in law, subject to Constitutional competence and is very often used by the Legislature to change the basis of a

⁷⁷ See Art. 74 of the Constitution of India 1950

⁷⁸ Amit M. Sachdeva, *Can the Proposed Tax Code Override Indian Tax Treaties?* 57 Tax Notes Int'l. 451–454, 451 (2010)

⁷⁹ Roy Rohatgi p.33

judicial decision.⁸⁰ However, “it is necessary that the legislature should be able to cure inadvertent defects in statutes of their administration by making what has been aptly called *small repairs*”.⁸¹ However on the other hand, it hampers taxpayers’ opportunity to carry out cost-benefit analysis of the proposed transaction and to decide whether or not to enter into such a transaction.⁸²

Indian Parliament’s rampant retrospective amendment to tax laws were questioned when India’s rank on the World Bank’s Doing Business report⁸³ was below countries like Uganda, Ethiopia, Yemen et cetera while its smaller neighbours like Sri Lanka fared better.⁸⁴ In response to this, Damodaran Committee⁸⁵ viewed that:

*“.....death and taxes are equally undesirable aspects of human life. Yet, it can be said in favour of death that it is never retrospective.....improvements should be attempted sooner rather than later since business cannot take corrective action retrospectively.”*⁸⁶

The spate of retrospective amendments has created uncertainties and instability among the foreign investors in India. The same sentiments were echoed by Parthsarthy Shome Committee set up by the Ministry of Finance which proposed that “*retrospective application of tax law should occur in exceptional or rarest of rare cases*”⁸⁷. Further the Committee laid down the objectives with which retrospective amendments should be made. First to “correct

⁸⁰ KumKum Sen, Retrospective Amendments to tax laws? An Ongoing Battle March 26,2012 Business Standard available at: http://www.business-standard.com/article/economy-policy/retrospective-amendments-to-tax-laws-an-ongoing-battle-112032600018_1.html

⁸¹ The Supreme Court stated this in Buckingham and Carnatic Mills case while citing Harvard Law review

⁸² Pradip R. Shah, *Retrospective Amendments – High-time for Introspection by India*, April 1, 2010 available at <http://www.caclubindia.com/articles/retrospective-amendments-high-time-for-introspection-by-india-5144.asp#.UxCo-PmSxAE>

⁸³ 2012 Report referred By Damodaran Committee in its report submitted to the Ministry of Corporate Affairs available at : http://www.mca.gov.in/Ministry/annual_reports/DamodaranCommitteeReport.pdf

⁸⁴ Retrospective Taxation: the Indian Experience by Harish Salve , available at : http://www.biicl.org/files/6722_panel_two_harish_salve.pdf

⁸⁵ Set up by the Ministry of Corporate Affairs. Submitted its report on 2nd September 2013. available at http://www.mca.gov.in/Ministry/annual_reports/DamodaranCommitteeReport.pdf

⁸⁶ Damodaran Committee Report, available at : http://www.mca.gov.in/Ministry/annual_reports/DamodaranCommitteeReport.pdf

⁸⁷ Shome Committee Draft Report On Retro Tax Changes, Business World,(Oct. 9, 2012) available at: <http://www.businessworld.in/news/finance/shome-committee-draft-report-on-retro-tax-changes/566865/page-1.html>

apparent mistakes/anomalies in the statute; second, to apply to matters that are genuinely clarificatory in nature, i.e. to remove technical defects, particularly in procedure, which have vitiated the substantive law; or, third, to “protect” the tax base from highly abusive tax planning schemes that have the main purpose of avoiding tax, without economic substance, but not to “expand” the tax base.....”⁸⁸.

Ironically in India, providing clarification is often merely a euphemism for amending the law and typically leads to a completely different interpretation from that which was gained by prior plain reading.⁸⁹ One such clarificatory amendment was introduced by the Finance Bill 2012 to nullify the effect of Supreme Court’s decision in *Vodafone International Holdings B.V. v. UOI & Anr.*⁹⁰ Vodafone Style Transactions were held not to be taxable by the Apex Court in light of Section 9 of the Income Tax Act, 1961 which was interpreted to cover “.....only income arising from a transfer of a capital asset situated in India and it does not purport to cover income arising from the indirect transfer of capital asset in India”⁹¹. The clarificatory retrospective amendment restated the scope and applicability of Section 9 by giving rights to the Revenue to tax such indirect transfers retrospectively from 1st April, 1962.⁹²

This step by the Parliament of India forced atleast half a dozen companies to either withdraw from India or re-direct their investment plans.⁹³ However, soon Andhra Pradesh High Court’s ruling on India-France Double Treaty Tax Avoidance Agreement (hereinafter referred as

⁸⁸ Parth Sarthy Shome Committee Report Cited in Draft Report of the Expert Committee on Retrospective Amendments Relating to Indirect Transfer available at: http://www.incometaxindia.gov.in/archive/DraftReport_10102012.pdf

⁸⁹ Retrospective Amendments, International Tax Review, October 2012 Also available at <http://www.te-ba.com/content/retrospective-amendments-itr-article>

⁹⁰ *Vodafone International Holdings B.V. v. UOI & Anr.* (2012) 6 SCC 613

⁹¹ *Ibid.*

⁹² Finance Bill 201, available at: <http://indiabudget.nic.in/ub2012-13/mem/mem1.pdf>

⁹³ Retrospective Amendments, International Tax Review, October 2012 Also Available at <http://www.te-ba.com/content/retrospective-amendments-itr-article>

“DTAA”) in *Sanofi Pastuer Holding SA V. Dept. Of Revenue*⁹⁴ came as a respite to foreign investors. The court held that the retrospective amendments to the Income Tax Act, 1961 vide Finance Act, 2012 have no impact on the interpretation of DTAA between India and France. Thus, the capital gains arising on sale of shares of ShanH, a tax resident of France were held to be taxable exclusively in France as per Article 14(5) of the DTAA.

Another major clarificatory retrospective amendment by Finance Bill 2012 widening the ambit of term ‘royalty’⁹⁵ in Section 9(1)(vi) of the Income Tax Act unsettled tax position relating to software payments and payments to telecasting companies. The Delhi High Court once again came for the rescue of foreign investors in *Director of Income Tax V. M/s Nokia Networks OY*⁹⁶ wherein it held that the consideration for supplying software (embedded in telecommunication GSM system) is not taxable as ‘royalty’ even after retrospective amendment to the Income Tax Act, 1961(vide Finance Act 2012) in terms of the India-Finland Double Taxation Avoidance Agreement. This ruling by Delhi high Court after the introduction of retrospective amendment, affirming the position that tax treaty benefit will not be affected by the change in the domestic law came as a relief to software vendors and connectivity service providers protected by tax treaties.⁹⁷

Another moment of relief was provided by Mumbai Income Tax Appellate Tribunal in *WNS North America versus the Income Tax Department*⁹⁸ wherein it held that retrospectively amending the definition of ‘royalty’ in the Income Tax Act, 1961 cannot automatically alter the provisions of Double Taxation Avoidance Agreements (India- US tax avoidance pact in this case).

⁹⁴ *Sanofi Pastuer Holding SA V. Dept. Of Revenue [2013] 30 taxman.com 222 (AP)*.

⁹⁵ *Supra* note 92

⁹⁶ *DIT v. Nokia Networks OY (TS-700-HC-2012(Del))*

⁹⁷ *Comments by PwC News Alert (Sept. 2012)*

http://www.pwc.in/services/tax/news_alert/2012/pdf/pwc_news_alert_14_september_2012_nokia_networks_oy.pdf

⁹⁸ *North America v. Income Tax Department, [TS-895-ITAT-2012(Mum)]*

The tribunal viewed that:

“A country who is party to a treaty cannot unilaterally alter its provisions. If there is no amendment to the provision of the treaty but there is some amendments adverse to the assessee in the Act, which provisions has been specifically defined in the treaty or there is no reference in the treaty... the amendment... shall have no unfavourable effect on the computation of total income of the assessee.”

The ruling has re-iterated that retrospective amendments in the domestic tax law do not impact the provisions in the tax treaty, unless either the treaty has also been amended on the same lines as the domestic law, or the particular provision in the tax treaty refers back to the domestic law.⁹⁹

However, the solemn assurance by the Finance Minister at the beginning of the discussion of the Finance Bill 2012 in Lok Sabha confirming that “clarificatory amendments do not override the provisions of Double Taxation Avoidance Agreement (DTAA) which India has with 82 countries; it would impact those cases where the transaction has been routed through low tax or no tax countries with whom India does not have a DTAA”¹⁰⁰ needs to be questioned. Regardless of the motives for legislating retrospectively, the development is a deeply worrying one for taxpayers and their advisers. As the Vodafone saga has shown, employing retrospective amendments can have far-reaching and long-lasting repercussions. And while taxpayers and their advisers are already aware of a number of likely retrospective amendments in the year ahead, governments should take note of the adverse effects on

⁹⁹ ITAT: No Scope for Unilateral Changes in Tax Treaties Available at: <http://archive.indianexpress.com/news/itat-no-scope-for-unilateral-changes-in-taxation-treaties/1051212/>

¹⁰⁰ Opening Remarks made by the Finance Minister Shri Pranab Mukherjee at the beginning of the Discussion on Finance Bill 2012 on 7th May, 2012, available at: <http://pib.nic.in/newsite/erelease.aspx?relid=83240>

investment, and make a decision as to whether invoking retroactivity to bolster revenues will actually be counterproductive when this is taken into account.¹⁰¹

C. GAARS & LOBS

Revenue authorities across the globe have fought tooth and nail to avert and curb the ill of tax avoidance but could not come up to scratch. This prompted the countries like Australia¹⁰², Canada¹⁰³, China,¹⁰⁴ South Africa to empower their revenue authorities by incorporating anti avoidance rules in their domestic tax laws. In most cases, tax avoidance measures have their beginnings in the *fraus legis* principle from Roman law. According to this, a person cannot rely on recourse to the law when he in bad faith aspires to gain from the exercise of his subjective right. This principle, transposed from private law, has been successfully applied in developing measures to prevent tax avoidance¹⁰⁵, both in the form of a provision of law and as a doctrine evolving in judicial practice.¹⁰⁶

The case of India is no different which has proposed to introduce a GAAR¹⁰⁷ in the Income Tax Law giving wide discretionary powers to the Indian Revenue Authorities to invalidate an arrangement; including disregarding application of tax treaties, if an arrangement is treated as an ‘impressible avoidance arrangement’.¹⁰⁸ However, India has Specific Anti Avoidance

¹⁰¹ Retrospective Amendments, International Tax Review, October 2012 Also Available at <http://www.te-ba.com/content/retrospective-amendments-itr-article>

¹⁰² Australia’s GAAR was introduced in 1981 and is contained in Part IVA of the Income Tax Assessment Act 1936.

¹⁰³ Canadian tax laws contain GAAR provisions since 1988.

¹⁰⁴ The new EITL18, which came into effect on 1 January 2008, includes a general anti-avoidance provision (Article 47 of the EITL) Enterprise Income Tax Law

¹⁰⁵ F. Zimmer. – Form and substance in tax law. Studies on International Fiscal Law by the International Fiscal Association. Volume LXXXVIIa. Kluwer 2002, pp. 41–42 Exceptions are Belgium and Italy, both of whom maintain that the concept of *fraus legis* is applicable only in civil law and not in tax matters;

¹⁰⁶ Tabet Grauberg, Anti-tax-avoidance Measures and Their Compliance with Community Law, *Juridica International XVI/2009*. available at: http://www.juridicainternational.eu/public/pdf/ji_2009_1_141.pdf

¹⁰⁷ The press report released by the Finance Minister states that GAAR shall come into effect from April 1, 2016.

¹⁰⁸ Rajendra Nayak & Astha Jain ¹⁰⁸India: Rules for application of general anti-avoidance rules available at: <http://www.internationaltaxreview.com/Article/3272449/India-Rules-for-application-of-general-anti-avoidance-rules.html>

Rules (SAAR) in domestic tax laws¹⁰⁹ as well as Limitation of Benefit Clause in some tax treaties¹¹⁰. Even though India is not a party to the VCLT but generally follows the VCLT rules as codification of customary international law.¹¹¹ The basic question arises whether or not the application of a domestic GAAR could be in breach of the “*pacta sunt servanda*” principle¹¹².

Certain states have decided to expressly allow, in a tax treaty context, the application of domestic anti avoidance rules. This is the case for example, in several Canadian¹¹³, Belgian¹¹⁴ and Spanish¹¹⁵ tax treaties. With different nuances the wording of these treaty rules provided as follows:

“Nothing in the agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonable be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State”.¹¹⁶

Even if this kind of provision has been severely criticized by the scholars¹¹⁷, it is obvious that they allow going beyond the possible sense of the treaty wording and, therefore, prevent an eventual breach of the *pacta sunt servanda* principle.¹¹⁸

¹⁰⁹ Sections 2(22)(e), 60, 61, 64, 94, Explanation 3 to section 43(1), Explanation 4A to section 43(1), sections 56(2)(vii), 56(2)(viii), 40A(2) of the Income Tax Act, 1961. For detail refer to Removing the fences looking through GAAR, Price Water House Cooper, February 2012, available at <http://www.pwc.com/in/en/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf>

¹¹⁰ For example India-Singapore Tax Treaty discussed in this section of the paper.

¹¹¹ Supra note 10

¹¹² Article 26, VCLT

¹¹³ Article 29(6) of the Canada- Germany tax Treaty and Article 29 A(7) of the Canada US-Tax Treaty (quoted by Loomer, Tax Treaty Abuse: Is Canada responding effectively, (2009)

¹¹⁴ De Broe, International Tax Planning and Prevention of Abuse Tax Treaties with Germany, Luxembourg, Austria, Egypt and Hongkong; (2008), p.461

¹¹⁵ Ibid, Tax Treaty with Costa Rica

¹¹⁶ Ibid, For different models see De Broe, International Tax Planning and Prevention of Abuse (2008), p.462

¹¹⁷ These provisions are considered to have been drafted less rigorously than special LOBs (Loomer, Tax Treaty Abuse: Is Canada Responding effectively? 2009 p.48

¹¹⁸ Gracis Prats, F.A. The Abuse of Tax Law: Prospects and Analysis in Bizoli (ed.) Essays in International and European Tax Law (Napoli; Jovene, 2010) p.49

The situation turns problematic in those cases in which tax treaties are silent on the application of GAAR in the treaty context. But, even for these cases some jurisdictions, and a wide range of scholars¹¹⁹, take the view that a principle prohibiting treaty abuse is inherent in tax treaties. The existence of this principle is frequently linked to the general principles recognized by civilized nations according to Art. 38(1) of the Statute of ICJ. Moreover, this seems to be also in line with the recent birth of a general principle of abuse of law in general community law¹²⁰ and at least in a bilateral dimension, the OECD Commentaries¹²¹ also flirt with that idea.

Under the Vienna Convention, international agreements are to be interpreted in ‘good faith’.¹²² In case any international agreement/treaty leads to unintended consequences like tax evasion or flow of benefits to unintended person, it is open to the signatory to take corrective steps to prevent abuse of the treaty. Such corrective steps are consistent with the obligations under the Vienna Convention. Further, the OECD Commentary on Article 1 of the Model Tax Convention also clarifies that a general anti-abuse provision in the domestic law in the nature of “substance over form rule” or “economic substance rule” is not in conflict with the treaty. Any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied.¹²³ A similar view has been taken by Committee of Experts on International Cooperation in Tax Matters, UN (Committee) in its Report, issued during its fourth session in Geneva on 20 -24 October 2008.

¹²⁴ The expert Committee on GAAR headed by Parthasarathi Shome Panel highlighted that the objective of GAAR should be ‘deterrence rather than revenue’ and recommended that GAAR

¹¹⁹ Ward D.A. *Ward’s Tax Treaties 1996-1997* (Toronto: Carswell, 1996) p.61. Vogel, K. Klaus Vogel on *Double Taxation Conventions*, 3rd ed. (London: Kluwer Law International, 1997) p. 125

¹²⁰ *Supra* note. 114

¹²¹ OECD Commentary Article 1 Para 7.1

¹²² Article 26, VCLT

¹²³ *Ibid.* at p. 24

¹²⁴ White Paper on GAAR, PWC, *available at*: <http://www.pwc.in/assets/pdfs/publications-2012/pwc-white-paper-on-gaar.pdf>

should apply “*only in cases of abusive, contrived and artificial arrangements*”¹²⁵. The second issue dealt by the committee was pertaining to LOBs in the tax treaties. It took a view that there may be conflict with treaty provisions which specifically have SAAR in the form of limitation of benefits clause etc. as the tax avoidance is being addressed both in the domestic law as well as the treaty law. It should, therefore be clarified through subordinate legislation so that there is no treaty override where the treaty itself has anti-avoidance provisions in the form of limitation of benefits clause.¹²⁶

Limitation of Benefits (LOB) is a concept invented by the United States of America which was gradually sanctified as a practice by the OECD and followed by other countries.¹²⁷ LOB is an anti-abuse provision that restricts eligibility criteria for third country (other than the contracting States) residents to obtain benefits under a Double Taxation Avoidance Agreement (DTAA).¹²⁸ Internationally, in their efforts to combat treaty abuse, many states have renegotiated their treaties to include an LOB article or have unilaterally enacted Treaty Override provisions in their local law.¹²⁹ For example, China, which had entered into a favourable tax treaty with Mauritius, renegotiated its treaty a few years ago to include an LOB clause to prevent misuse of the treaty for avoidance of capital gains taxation.¹³⁰

India has generally adopted an approach of having greater emphasis on source country taxation, discouraging treaty shopping was usually not a significant policy goal for India, while negotiating tax treaties. Therefore, most of India’s earlier tax treaties do not contain

¹²⁵ Final Report on General Anti Avoidance Rules (GAAR) in Income-tax Act, 1961 ,
available at: http://finmin.nic.in/reports/report_gaar_itact1961.pdf

¹²⁶ Ibid

¹²⁷ D P Sengupta ,The Shome GAAR - Lob(bing) Back to The Committee
Nov 02, 2012 *available at:* <http://www.taxindiainternational.com/columnDesc.php?qwer43fcxzt=MTEz>

¹²⁸ Anshu Khanna , Walking the extra mile , The Hindu, *available at :*
<http://www.thehindubusinessline.com/features/taxation-and-accounts/walking-the-extra-mile/article5541678.ece>

¹²⁹ Mukesh Butani ,In Defence of Tax Treaties, Business World, (Feb. 28, 2011) *available at:*
<http://www.businessworld.in/news/opinion/columnists/in-defence-of-tax-treaties/706411/page-1.html#sthash.W1ZeXZjA.dpuf>

¹³⁰ Ibid.

anti-treaty shopping provisions.¹³¹ However, the Singapore Tax Treaty, as renegotiated in 2005, includes a Limitation on Benefit provision to prevent abuse of the capital gains tax benefit. Post this development; most of India's new or renegotiated tax treaties contain a LOB clause (tax treaties with countries such as Mexico, Saudi Arabia, UAE, Norway, and Luxembourg).¹³²

Singapore has a similar exemption to that in India-Mauritius tax treaty with respect to capital gains taxes in its treaty with India, but it is harder to qualify as a tax resident in Singapore due to a "limitation of benefits" clause in its treaty. A Singapore-like limitation of benefits clause needs to be added to the Mauritius treaty before a general anti-tax avoidance rule goes into effect in India that would override the treaty protections for companies using bare holding companies in Mauritius to take advantage of the India-Mauritius tax treaty.¹³³ Recently, Mauritius and India have agreed on the principle of including a limitation of benefits clause in the treaty.¹³⁴

Although it is too early to tell how extensive this shift in policy will become, for now Indian seems to be following a similar path taken by United States in 1980s when it began renegotiating its income tax treaties and began insisting that treaty partners agree to having LOB provisions in the renegotiated treaties.¹³⁵ United States of America believe that such provisions are effective in stopping aggressive international tax planning that uses its treaties for the benefit of third country residents.¹³⁶

¹³¹ Sudheer Kapadia, Holding Company for Indian Investments International Tax Review, *available at:* <http://www.internationaltaxreview.com/Article/3068212/India-Holding-company-planning-for-Indian-investments.html>

¹³² Ibid.

¹³³ Chadbourn & Park LLP, The Mauritius India Tax Treaty (Dec 2013) *available at:* <http://www.chadbourne.com/The-Mauritius-India-Tax-Treaty-12-04-2013/>

¹³⁴ Mauritius, India Agree to Lob Clause, The Hindu, (Dec. 10, 2013), *available at:* <http://www.thehindu.com/business/mauritius-india-agree-to-lob-clause/article5440954.ece>

¹³⁵ Declan Gavin & Cecile Gules, *Limitation of Benefits Provisions in Income Tax Treaties*, World Wide Tax Review (May 2008), *available at:* <http://www.bcasonline.org/articles/artin.asp?771>

¹³⁶ Ibid.

D. THE CURIOUS CASE OF CYPRUS

At the close of the year 2013, Indian Government issued a Notification¹³⁷ invoking Section 94A of the Income Tax Act, 1961 targeting transactions with persons located in Cyprus. The Finance Act, 2011 inserted Section 94A as an anti avoidance measure in the Income Tax Act “to discourage transactions by a resident assessee with persons located in any country or jurisdiction which does not effectively exchange information with India”.¹³⁸ This provision has been termed as a “toolbox of counter measures in respect of transactions with entities in notified jurisdictional areas”¹³⁹ which enables the Central Government to blacklist a country which does not co-operate on effective exchange of information.

India is not the first one to brush Cyprus as ‘non co-operative’ Russia had taken to a similar exceptional measure in 2008 despite Cyprus emerging as a leading financial centre for inbound and outbound foreign investments from and into Russia.¹⁴⁰ The ice in the relation was broken when Protocol to the 1998 Double Tax Treaty containing a provision on ‘exchange of information’ was signed between Cyprus and Russia.¹⁴¹ Huge investments pour in India from Cyprus in the real estate sector which is primarily in form of Compulsory Convertible Debentures.¹⁴² Article 28 of Cyprus-India tax treaty “provides for exchange of information between the countries to prevent fraud or evasion of tax”.¹⁴³ India alleged that Cyprus has not been providing the information requested by the Indian tax authorities and

¹³⁷ Notification No. 86/2013 dated November 1, 2013 published in Official Gazette through SO 4625 GI/13.

¹³⁸ Final Report on General Anti Avoidance Rules (GAAR) in Income-tax Act, 1961, available at <http://indiabudget.nic.in/ub2011-12/mem/mem1.pdf> (Last visited Feb. 28, 2014)

¹³⁹ Ibid.

¹⁴⁰ Mukesh bhutani, Cyprus Faces heat over Tax Treaty Business Standard, (Nov. 10, 2013) available at: http://www.business-standard.com/article/opinion/mukesh-butani-cyprus-faces-heat-over-tax-treaty-113111000704_1.html

¹⁴¹ Russia-Cyprus Protocol to Tax Treaty signed, (Oct. 7, 2010) available at: https://www.deloitte.com/view/en_CY/cy/insights/Publications/cy-pubs-10/cy-pubs-10-tax/8f44f213a378b210VgnVCM3000001c56f00aRCRD.htm

¹⁴² Ajay Kumar, *India Cyprus Treaty Override - Problems and Solutions*, Taxsutra, available at: <http://www.taxsutra.com/experts/column?sid=140>

¹⁴³ Text Cyprus-India Double Tax Treaty LLPO Law Firm, (2010) available at: <http://webcache.googleusercontent.com/search?q=cache:http://llpolawfirm.com/india-cyprus-double-tax-treaty.html>

thus notified Cyprus as a notified jurisdictional area.¹⁴⁴ The notification by Indian Government has grave implications on taxpayers who are especially worried ‘about payments made to a person located in Cyprus for which they shall be liable for withholding tax at 30 per cent or a rate prescribed in Act, whichever is higher’.¹⁴⁵

It is argued that the procedural requirements requiring disclosure of information may not amount to overriding a bilateral tax treaty; but subjecting all transactions with Cyprus to transfer pricing evaluation or to a higher withholding tax rate of 30 percent is a case of unilateral override by India of the India–Cyprus tax treaty.¹⁴⁶ It was further suggested that in the present case where the bilateral tax treaty is still in force, the correct way for the Indian government would have been to first revoke the bilateral tax treaty rather than unilaterally overriding it.¹⁴⁷ However, within a month of release of the notification, Cyprus agreed that “provisions of the new Article 26 of the OECD model tax convention relating to exchange of information” will be adopted in the new Double Taxation treaty between India and Cyprus.¹⁴⁸ Cyprus Finance Minister also assured for an improved communication and efforts in “processing requests and responses in a swift and effective manner”. By the Cypriot tax authorities.¹⁴⁹ Subsequently, Cyprus government issued a press release stated that it is expected India will retroactively rescind the notification notifying Cyprus as notified

¹⁴⁴ Notification No. 86/2013 dated 1st November, 2013 published in Official Gazette through SO 4625 GI/13. <http://pib.nic.in/newsite/erelease.aspx?relid=100369>

¹⁴⁵ Ibid.

¹⁴⁶ India Unilaterally Overrides Bilateral Treaty with Cyprus Sagar Wagh <http://www.neurope.eu/article/india-unilaterally-overrides-bilateral-tax-treaty-cyprus>

¹⁴⁷ Ibid.

¹⁴⁸ C.Savva & Associates Ltd., Mondaq, (Jan. 13, 2014), available at: <http://www.mondaq.com/x/285756/tax+treaties/India+Cyprus+Negotiate+New+Tax+Treaty>

¹⁴⁹ Stephanie Soong Johnston Practitioner, *Welcome Cyprus-India Tax Treaty Negotiation, Tax Analysts Document Service*, available at: http://www.neocleous.com/assets/modules/neo/news_events/1792/docs/2013-28188.pdf

jurisdictional area based on its consultation with Indian officials in late November. However, no such rescindment has been officially declared by India till date.¹⁵⁰

In the aftermath of the global financial crisis, there is increased recognition on the part of countries that improvements in exchange of information in tax matters are a part of a broader agenda to improve transparency and global governance.¹⁵¹ As a result Singapore and India have renegotiated their tax treaty by incorporating provisions facilitating mutual co-operation by effective exchange of information in tax matters.¹⁵² Further to address the problem, India is working closely with G20 on formulation of Common Reporting Standards (CRS) which will allow all the member countries to automatically share information pertaining to tax. India is working towards putting in place its IT infrastructure for CRS, which is likely to come into force by 2015.¹⁵³

V. REMEDIES TO TAX TREATY OVERRIDE

Due to the Sovereign nature of states other states cannot infringe upon sovereign duties of other states. It is upon the discretion of each state to unilaterally pass domestic law to override tax treaty. However, there are some limited steps that can be taken by the international community. In case provisions are breached the VCLT allows the termination or suspension either in whole or part of such articles.¹⁵⁴ It may also be possible to demand compulsory independent adjudication and penalties through an international forum. It may threaten or impose retaliatory measures. Some treaties and treaty provisions, which are conditional upon reciprocity, may cease to have effect.

¹⁵⁰ Ibid.

¹⁵¹ India Amends Tax Treaty With Singapore, The Hindu, *available at*: <http://www.thehindu.com/business/Economy/india-amends-tax-treaty-with-singapore/article2132285.ece>

¹⁵² Ibid.

¹⁵³ Lubna Kable, India Cyprus Double tax avoidance Agreement to be Finalised, Times of India, (Feb. 11, 2014) *available at*: <http://timesofindia.indiatimes.com/business/india-business/India-Cyprus-double-tax-avoidance-agreement-to-be-finalised-soon/articleshow/30228395.cms>

¹⁵⁴ Article 60: 2 (b)

Clasula rebus sic stantibus or the concept “Fundamental change of circumstances” can lead to treaty termination in certain circumstances, but it does not justify a treaty override.¹⁵⁵ The fundamental change must not be the result of a treaty breach by the party invoking it. Similarly, an “ impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any of the party of the treaty.”¹⁵⁶

In the case of a treaty violation either contracting states could:

- a. Make an official protest and invoke the mutual agreement procedures under the OCED Model Convention Article 25. The OECD treaty override Report 1989 urged its members to refrain from such actions, still we see Canada overriding almost all of its treaties. In future if Canada does not comply with such norms it will lose its membership to the OECD.
- b. Retaliate with similar domestic override;
- c. Appeal to an international forum e.g. International Court of Justice.¹⁵⁷
- d. Terminate or suspend the treaty as a “material breach” (but cannot sue) under customary international law and practice.¹⁵⁸ For instance, in June 29, 1987 the United States Treasury Department terminated the US-Netherlands Antilles Tax Treaty.¹⁵⁹ Negotiations ended because of the extent that Netherlands was a tax haven. As much as it was on treaty shipping. The termination was a victory to the US because third party countries could no longer use it to evade US taxes.

¹⁵⁵ Model Tax Convention on Income and on Capital 2010: Full Version R(8). Tax treaty override, *available at*: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2010/r-8-tax-treaty-override_9789264175181-101-en#page10

¹⁵⁶ Article, 61(2) VCLT

¹⁵⁷ Article, 66 VCLT

¹⁵⁸ Article, 60 VCLT

¹⁵⁹ Frith Crandall, *The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping*, NW J. Int'l L. & Bus 359 (1988)

VI. CONCLUSION

“Even if an ordinary man makes a statement which is just and fair; it should be accepted. And if a statement is unjust and unfair – even if told by a Vedic Rishi; it should be rejected. Man must always follow justice.”¹⁶⁰

Sovereign nations in a similar fashion are not willing to accept unfair and unjust avoidance of tax by the foreign investors in the garb of tax treaties. As a result a majority of countries have either incorporated anti-avoidance rules in their domestic laws or renegotiated their tax treaties. However, Philip Baker argues that countering anti-avoidance through domestic tax rules cannot justify a unilateral treaty override and could amount to a breach of international obligation.¹⁶¹ Unilateral attempts by the State to circumvent or dodge a treaty could amount to infringement of the international legal duty to fulfil the treaties that it concluded in good faith¹⁶². Such unilateral behaviour is the antithesis of successful foreign relations.¹⁶³ Still, Klaus Vogel argues that the acceptance of new law for sometime by the other contracting state may constitute subsequent practice under Article 31(3) (b) of VCLT.¹⁶⁴

India unlike the US has in a majority of instances preferred to renegotiate instead of terminating a treaty as argued in the paper. Termination of tax treaty is generally condemned as it impairs the economy as well as it minimizes the possibility of finding an acceptable solution in future.¹⁶⁵ India has been wise enough not to take this extreme step. The Indian Judiciary have tipped the scales in favour of foreign investors by ensuring that clarificatory retrospective amendments do not affect the tax treaty obligations of Indian government. We

¹⁶⁰ Yoga Vashisthya Book II “Mumukshu Prakarana”, Chapter 18, shloka as cited in “Treaty Override” by Rashmin Chandulal Sanghvi *available at*: http://www.rashminsanghvi.com/downloads/taxation/international-taxation/Treaty_Override-paper_by_Rashmin.pdf

¹⁶¹ Philip Baker, Double Tax Conventions (Sweet & Maxwell,2003)

¹⁶² Article 26, VCLT

¹⁶³ Supra note.159

¹⁶⁴ Klaus Vogel, Double Taxation Conventions, Introduction m.nos. 125-126

¹⁶⁵ OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides,” *Tax Notes Int’l*, Jan. 1, 1990, p. 25, 90 *TNI* 7-13.

conclude, that even in the rarest of rare cases countries should try to either renegotiate their tax treaties to toe with the changing foreign investment environment or opt for mutual agreement procedure.

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