GAAR TO OVERRIDE DTAAS: CAN THE CONSTITUTION OR LIMITATION OF BENEFITS CLAUSES PREVENT THIS MENACE?

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An amendment to the Income Tax Act, 1961 has introduced the General Anti-Avoidance Rules (‘GAAR’), which came into force from April 1, 2017. The GAAR seeks to clamp down on tax avoidance generally, including through Direct Taxation Avoidance Agreements (‘DTAA’). However, the application of the GAAR to treaties is likely to be arbitrary and to result in severe consequences. It is also likely to lead to harassment of assesses on account of a scrutiny of genuine transactions and lengthy procedural compliances. A constitutional challenge to the GAAR is likely on grounds that it overrides India’s international obligations. We analyse that under the constitutional scheme, treaty override is permissible, as Articles 253 and 246 are at the same pedestal, where a law made in pursuance of international obligations does not override other national laws. The validity of national laws is not affected by the presence of international obligations either. Breach of those obligations only gives rise to suitable remedies in international law. As a result, it is likely that such a challenge would fail, and GAAR would apply to DTAAs. Simultaneously, there has been another development that merits consideration; several of India’s new and re-negotiated DTAAs, including the India-Mauritius treaty, contain Limitation of Benefits clauses to prevent the use of these treaties as devices for tax avoidance. To prevent the harassment that would ensue from an application of GAAR to DTAAs, we argue that the GAAR should not apply to treaties having Limitation of Benefits clauses, as the latter can accomplish the same purpose without the accompanying uncertainty and harassment. This can be done by excluding these treaties from the scope of GAAR.

I. INTRODUCTION

Historically, the Supreme Court of India has recognized the distinction between tax planning, avoidance and evasion.¹ Tax planning is structuring one’s affairs in a manner that minimises tax liabilities, by availing

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various exemptions and deductions available under the law. Tax evasion, on the other hand, is not discharging one’s tax liabilities by violating the law. Between this spectrum of tax planning and tax evasion lies tax avoidance. Tax avoidance is utilizing loopholes available in the law to minimise liability. Although legal, tax avoidance defeats the purpose of the law and leads to a loss of revenue to the Exchequer. Consequently, the Legislature and the Executive constantly attempt to clamp down on avoidance mechanisms.2

A popular method of tax avoidance is through corporations set up in low-tax jurisdictions with which India has entered into tax treaties. The most notable among these treaties is the one between India and Mauritius (‘treaty’).3 Effectively, it allows for the non-taxation of capital gains arising out of the sale of shares of Indian companies. Under the treaty, all capital gains will be taxed in the country of residence, regardless of where the income arises.4 Mauritius is a low-tax jurisdiction and does not levy capital gains tax. As a result, it has been the source of almost a third of all foreign direct investment in India over the years.5 However, the treaty has also been misused through various devices merely to avail these benefits.6 There have been several attempts to limit the benefits of the treaty only to those genuinely entitled to them, but these have met with limited success.7 In a significant breakaway, the treaty has been amended by way of a Protocol. With effect from April 1, 2019, the non-taxation of capital gains arising out of the alienation of shares of Indian companies shall be done away with. The Protocol has also introduced measures, namely, ‘Limitation of Benefits’ clauses, to prevent the misuse of the treaty benefits till that date.8

5 Department of Industrial Policy and Promotion, Fact Sheet on Foreign Direct Investment (FDI), available at http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_April_Sep_2016.pdf (Last visited on December 3, 2016).
6 A prominent example of the misuse of India-Mauritius DTAA has been the round-tripping of funds. Black money holders in India have used this treaty to make investments into India. Not only has this enabled them to channel their black money into the formal economy, it has allowed this to be done without any tax liability. See Remya Nair, Mauritius to Address India’s Concerns over Tax Treaty, Livemint July 15, 2013, http://www.livemint.com/Politics/DST9ljWFK804D9hbOlY3hI/Mauritius-to-address-concerns-over-tax-treaty.html (Last visited on March 19, 2017); Rajesh Kumar Singh & Santanu Chakraborty, India Acts to stop investors using Mauritius as Tax Shelter, Bloomberg May 10, 2016, https://www.bloomberg.com/news/articles/2016-05-10/india-reworks-taxation-treaty-with-mauritius-to-prevent-evasion (Last visited on March 19, 2017).
8 Art. 8, Protocol Amending the Convention Between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of
A concurrent and important development that will have a substantial bearing on the avoidance of tax, through the use of treaties, has come in the form of an amendment to the Income Tax Act, 1961 (‘the Act’).9 The amendment introduces the General Anti-Avoidance Rules (‘GAAR’), which shall come into force from April 1, 2017. GAAR empowers the Income Tax authorities to look through any arrangement that appears to be designed primarily to avoid taxes and subsequently, deny the benefits derived thereby. Cross-border transactions with low-tax treaty jurisdictions are expected to attract considerable scrutiny.10 This has raised concerns for not only those who have abused the treaties to avail benefits, but even those who have availed them legitimately. These concerns stem from the poor record of the Central Board of Direct Taxes, India in the implementation of the law.11 A commentator has even gone to the extent of saying that GAAR “will hang over international taxpayers like a Damocles sword”.12 In the past, implementation of the GAAR has been postponed, primarily due to plummeting investor confidence over arbitrary implementation of a vague law.13 Consequently, it would not be erroneous to expect a challenge to GAAR soon after its implementation.14 A ground on which the treaty may be

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challenged is whether it is permissible for a domestic legislation to unilaterally override a treaty. Conflicting High Court decisions on the subject have led to a lack of clarity over whether such a challenge can be sustained. In this paper, we examine the validity of treaty override under the Indian Constitutional framework as well as international law. We contend that that the challenge would not succeed. In light of this, we argue that it would be more fruitful to focus on the potential conflict between Limitation of Benefits clauses and GAAR – a conflict that may blind-side investors and may prove to be very litigious. The Government of India should, as a result, make suitable amendments in order to clarify the position of law.

We begin with an overview of the scope and nature of DTAAs and GAAR. Part II explains the concept of double taxation, the need for DTAAs and the significance of the India-Mauritius DTAA. Part III explains the concept of GAAR and its impact on measures of tax avoidance and on transactions channelled through DTAAs. In light of the potential impact of GAAR, we consider a challenge to its validity to be imminent. Thus, in Part IV, we examine the validity of treaty override – one of the grounds on which GAAR could be challenged. We contend that a treaty override is valid under both the domestic constitutional set-up and international law. Given that it is constitutional, we move towards an issue that could blind-side investors and could adversely affect their sentiment. In Part IV, we examine the conflict between Limitation of Benefits clauses and GAAR. We examine the source of this conflict, its impact and how another jurisdiction, Canada, has handled a similar situation. Finally, we conclude with a suggestion to resolve this conflict. Therefore, we contend that the application of GAAR to DTAAs is constitutional and can be improved considerably by modifying the law.

II. DOUBLE TAXATION AVOIDANCE AGREEMENTS

To lay down a conceptual foundation to analyse the interaction of GAAR and DTAAs, in this chapter we will examine, first, the need for DTAAs, second, the framework for DTAAs under the Income Tax Act, 1961 and third, the significance of the India-Mauritius DTAA.

A. THE CONCEPT OF DOUBLE TAXATION

Generally, countries impose taxes in two ways –either on the source of income or on the residence of an individual. When the source of
income lies within the territorial jurisdiction of a country, that country imposes
tax on the earner of the income. This type of taxation is known as source-based
taxation.16 Similarly, when an individual resides within the territorial jurisdic-
tion of a nation, that nation imposes tax on the income earned by her. This
type of taxation is referred to as residence-based taxation.17 What often hap-
pens is that ‘source-of-income’ based taxes may overlap with residence-based
taxes. In some situations, an individual who is a resident in one country may
earn income both within that country and within the territorial boundaries of
another country. In this case, the income earned in the foreign country will be
subject to tax both in that country and in the country where the individual re-
sides.18 Evidently, this is a case of double taxation and is unjust to the individual
concerned in that tax is paid twice on the same income.19 To prevent such dou-
ble taxation, countries provide unilateral relief20 or enter into bilateral treaties
known as ‘Double Taxation Avoidance Agreements’21

India has entered into nearly 90 DTAAAs with nations as well as
with specified territories such as Bermuda, British Virgin Islands, Cayman
Islands and Macau, among other such overseas territories and specially admin-
istered regions.22 The fact that the Government of India enters into a DTAA
with another nation does not mean that the DTAA will automatically be en-
forceable and applicable within the territorial boundaries of India. India follows
da dualistic system which means that to implement the DTAA the Parliament
will have to enact a law to this effect. This principle is enshrined in Article 253
of the Constitution.23 Notably, it would be quite cumbersome were there to be a
separate law for every DTAA. Therefore, the Parliament enacted Section 90 of
the Income Tax Act, 1961.24

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16 INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA (‘ICAI’), Double Taxation, 1, available at
dpdf (Last visited on August 25, 2016).
17 Id.
18 How to Get Relief in case of Double Taxation, TAXGURU August 1, 2012, http://taxguru.in/
21 AHUJA, supra note 19, 2384.
22 Id. (The authority to enter into such treaties stems from the Indian Constitution. Article 246 of
the Constitution read with Entry 14, List I of the Seventh Schedule confers upon the Parliament
the power to make laws vis-à-vis “entering into treaties and agreements with foreign countries
and implementing of treaties, agreements and conventions with foreign countries.” Article 73
of the Constitution says that the power of the Union Executive extends to “…matters with re-
spect to which Parliament has power to make laws”. When these provisions are read together,
it is observed that the Union Executive has the authority under the Constitution to enter into
treaties such as DTAA with other countries).
24 Kamlesh Chainani and Pinkesh Jain, Foreign Tax Credit on Income Exempt in India- A Much
Needed Relief!, 70 TAXMANN.COM 197 (2016).
B. THE CONCEPT EMBODIED BY SECTION 90

Section 90(1) confers upon the Union Executive the authority to enter into an agreement with any other foreign government or specified territory on issues of taxation. This authority is covered under two heads – first, to grant relief with respect to income on which double taxation has occurred or accrued and second, to avoid the double taxation of income.

When tax has been paid on the same income in both the jurisdictions, the first head allows the Central Government to grant relief. On the other hand, the second head says that agreements may be entered to avoid taxation under both the law in India and the corresponding law in the other jurisdiction. Thus, the first head deals with tax relief and the second head with avoidance of double taxation altogether. In the former, the assessee must pay tax upfront and then apply for relief in the form of a refund, whereas in the latter the assessee is exempt from paying tax on that income.

Section 90(2) complements sub-section (1) and states that when both the DTAA and the Income Tax Act are applicable to an assessee with respect to a tax relief or to the avoidance of double taxation, the one that is more beneficial to the assessee shall apply. Therefore, a composite reading of sub-sections (1) and (2) shows that the Parliament has not only authorized the Union Executive to enter into tax treaties with foreign governments but has also laid out how the treaties shall be implemented. When there is a conflict between the provisions of the Income Tax Act, 1961 and of the DTAs, the latter shall override the former so long as it is the more beneficial of the two.

C. SIGNIFICANCE OF THE INDIA-MAURITIUS TREATY

The India-Mauritius DTAA has been the source of a large amount of foreign investment as well as controversy over the years. The reason for this is that the India-Mauritius DTAA allows for double non-taxation and treaty shopping, making it a preferred route for investors.

Double non-taxation occurs because the treaty provides that all capital gains shall be taxed in the country of residence regardless of where the income arose. This also extends to capital gains arising from the alienation of

26 Id., §90(1).
28 See Central Board of Direct Taxes, Circular No. 333/1982 (April 4, 1982); See Ahuja, supra note 19, 2386.
As a result, capital gains arising in India, even from the sale of shares of Indian companies, would be taxed in Mauritius, provided the person was a resident of Mauritius. Mauritius is a low-tax jurisdiction, which does not levy capital gains tax. Thus, residents of Mauritius could avoid the capital gains tax in India, which was typically about 20%, under the terms of the treaty. This issue has come to be known as double non-taxation, as neither country ends up taxing these transactions.

When the treaty was signed, Mauritius was a small economy and their transactions with India were minimal. However, investors looking to invest in India sought to become residents of Mauritius to avail these benefits. Corporations were set up in Mauritius solely for investing in India. Several of these were shell companies, or corporations set up for round-tripping of funds. Such ‘treaty shopping’ led to a huge controversy. The Central Government clarified that the same was permissible by way of notification. The only requirement to prove residence was to obtain a Tax Residency Certificate (‘TRC’) issued by the Mauritian authorities. The Supreme Court in Azadi Bachao Andolan v. Union of India upheld the validity of these circulars.

The Supreme Court noted that treaty shopping was permissible and that if the Executive wished to prevent the same, it should have adopted a Limitation of Benefits clause. Moreover, the court also said that the validity of a TRC obtained in Mauritius could not be challenged in India.

Despite this Supreme Court ruling, the conclusiveness of TRCs continues to be contentious as a result of a subsequent Supreme Court decision in Vodafone International Holdings BV v. Union of India (‘Vodafone’) and amendments to the Act thereafter. Vodafone allowed the conclusiveness of TRCs to be challenged in cases of tax fraud, while the amendments allow the tax authorities to ask for further information apart from the TRCs. This

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31 Ranganathan, supra note 14.
32 Central Board of Direct Taxes, Circular No. 682/1994 (March 30, 1994).
33 Id.
35 Id.
36 Id.
38 In Vodafone, the Supreme Court permitted enquiries into the validity of TRCs in cases of tax fraud. In 2012, §90(4) was introduced by way of amendment; Finance Bill, 2012, Cls. 31 & 32, available at http://indiabudget.nic.in/ub2012-13/mem/mem1.pdf (Last visited on August 31, 2016); Finance Act, 2012, § 32; Memorandum to the Finance Bill, 2012 (The Explanatory Memorandum stated that this would be ‘a necessary but not sufficient condition for availing benefits of the agreements’); See Central Board of Direct Taxes, Notification 39/2012, (September 17, 2012); D. Jain, Proposed Amendment to Sections 90 and 90A(5) May be Rolled Back, 32 TAXMANN.COM 179 (2013) (However, this remedy did not prove to be particularly

April - June, 2017
lack of certainty has had a great impact on investor confidence over the years, particularly considering that almost a third of all foreign direct investment into India comes through Mauritius. From a policy perspective, it is essential that investor confidence is not dented by the lack of certainty in the tax regime. GAAR threatens to create a similar atmosphere of uncertainty, as shall be examined in the following part.

III. GENERAL ANTI-AVOIDANCE RULES

DTAAs are one of the many ways in which an assessee may derive some tax benefit or reduce overall tax liability. Over the years, the challenge has been that assesses have often made artificial structures (such as diverting income through businesses based in low tax jurisdictions) or used colourable devices (such as shell companies) to take the advantage of these benefits or of the reduced tax liability. This has led to an erosion of the tax base and consequently, a loss of revenue for the State. Thus, to restrict the loss the Act was amended in 2012 to introduce a new chapter – Chapter X-A (‘Chapter’) – that deals with ‘General Anti-Avoidance Rules’ (‘GAAR’).
To begin with, this Chapter states that an assessee cannot use an ‘impermissible avoidance arrangement’ to avoid tax. An impermissible avoidance arrangement is one that has been made only to derive a tax benefit, and (i) lacks commercial substance; or (ii) is not an arm’s length transaction; or (iii) results in a direct or indirect abuse of the provisions of the Act; or (iv) is carried out in a manner that is not bona fide.\(^{42}\) The assessing officer may presume an arrangement was for the main purpose of obtaining a tax benefit merely by showing that any step in the arrangement was for the purpose of obtaining a tax benefit. The burden is on the assessee to rebut this presumption.\(^{43}\) Moreover, the definition of tax benefit is very wide, and even includes any exemptions, deductions or other reduction of liability that may flow from tax treaties.\(^{44}\)

As a result, the powers of the tax authorities to scrutinise arrangements – to look at ownership structures, beneficial ownership, voting rights and so on – are very broad.\(^{45}\) It is expected that several devices designed primarily to avoid the payment of tax or to derive tax benefits will be affected.\(^{46}\) Simultaneously, several genuine commercial arrangements or any transactions that lead to a tax saving will also come under scrutiny.\(^{47}\) The use of DTAs to enjoy double non-taxation or to transfer income earned in India to a low-tax jurisdiction will thus come under scrutiny once the provisions of this Chapter come into force.\(^{48}\) Moreover, amendments have been made to the Act, which ensure that GAAR, when applicable, overrides the DTAA benefits.\(^{49}\)

Once an arrangement has been held to be an impermissible avoidance arrangement, certain consequences as are laid out in this chapter ensue. One of the main consequences is that the benefit as is provided under the Act or under a DTAA may be denied.\(^{50}\) For instance, in case of the India-Mauritius DTAA, this would mean that capital gains tax would be payable in India. Instead of there being no tax liability on the alienation of shares of Indian companies, 20% capital gains tax would be payable. In addition to that, the arrangement may be disregarded, re-characterised, may be considered as never having

\(^{42}\) Income Tax Act, 1961, § 96(1).
\(^{43}\) Id., § 96(2).
\(^{44}\) Id., § 102(10).
\(^{47}\) Anand, supra note 10.
\(^{48}\) Anand, supra note 10.
\(^{50}\) Income Tax Act, 1961, § 98.
been entered into, or the accruals, expenses, deductions or reliefs as provided in the arrangement may be reallocated.\footnote{Id., § 98} This threatens to have a domino effect. For instance, the re-allocation of expenditure or deductions among parties may alter their tax liabilities,\footnote{Id., §§ 95 & 100.} and may thus even attract penalties for misreporting of income.\footnote{Id., § 100, §§ 270A(2)(a) & (9) (read together).} These penalties may apply even if income had been disclosed and tax had been paid.\footnote{Income Tax Act, 1961, § 270A(1).}

Hence, what can be seen is that the application of GAAR may prove to be arbitrary with severe consequences. International transactions under DTAA are expected to undergo considerable scrutiny and GAAR may affect not only those who abuse DTAA, but also those genuinely entitled to benefits thereunder.\footnote{Admittedly, GAAR is a necessary step taken to stem the loss of revenue on account of erosion of the tax base. However, the application of GAAR to transactions channeled through the DTAA may considerably inconvenience investments and dampen investor confidence. This can be avoided because of the presence of revenue neutral alternatives. Therefore, the application of GAAR to DTAA may prove to be counter-productive.} A challenge to GAAR on the grounds of treaty override is thus imminent. The following chapter shall examine whether such a challenge is sustainable.

### IV. VALIDITY OF TREATY OVERRIDE

Section 90(2A) of the Income Tax Act, 1961 states, “Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him.” Whenever GAAR is applicable to an assessee, Section (2A) says that it shall apply instead of the provisions of the DTAA. This shall be the case irrespective of the fact that the DTAA may be more beneficial. In other words, in case of an inconsistency between the DTAA and the provisions of Chapter X-A, the statute shall override the treaty. Consequently, the assessee will be denied tax benefits of the DTAA. Whether such override is permissible or not has been a point of confusion.

#### A. TREATY OVERRIDE UNDER DOMESTIC LAW

In this Part, we will first describe the provisions of law applicable to this issue and show how the uncertainty vis-à-vis the permissibility of a statutory override has arisen. Various High Courts across the country have addressed this issue although in slightly different contexts. Unfortunately, there is no conclusive opinion yet on this point. Whereas one set of decisions has said that a statutory override of a treaty is constitutionally permissible; another set
of decisions has answered otherwise. Second, we will discuss these decisions. Third, we will explore what the position of law ought to be. We contend that a statutory override is permissible under the scheme of the Indian Constitution.

1. Constitutional Schema and the Source of Confusions

Article 245 is the source of legislative powers. It vests the Parliament and the State Legislatures with the power to make laws and demarcates the territorial extent of these laws. While it does confer these powers, it also places a fetter on the extent of the power. The laws made by the Parliament and the State Legislatures are “subject to the provisions of this Constitution”.\(^{57}\) Over the years, this phrase has been interpreted to include three things – the provisions of Part III of the Constitution, the distribution of legislative subjects between the Parliament and the States and any other provision of the Constitution that may impose restrictions, such as Article 303.\(^{58}\)

Article 246 deals with the second of these restrictions, namely, the distribution of legislative subjects between the Parliament and the State Legislatures, which should be read along with the Seventh Schedule. As per Article 246(1), the Parliament is conferred with exclusive powers to make laws with respect to matters contained in the Union List. As per the Union List, Parliament has the exclusive authority to make laws on matters of foreign policy, entering into treaties and agreements, implementation of such treaties and agreements and other allied matters.\(^{59}\)

Article 253 of the Constitution also covers an important principle dealing with India’s international obligations. It reads:

“Notwithstanding anything in the foregoing provisions of this Chapter, Parliament has power to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body.”\(^{60}\)

Therefore, there is an additional provision in the Constitution that confers the power to make laws upon the Parliament. These laws though, are to be limited to the implementation of any treaty, agreement, convention or other such decisions. As noted above, Section 90(2) of the Income Tax Act, 1961 is an

\(^{57}\) Constitution of India, Art. 245.

\(^{58}\) Powers, Privileges and Immunities of State Legislatures, In re, Special Reference No. 1 of 1964, AIR 1965 SC 745 : (1965) 1 SCR 413.


\(^{60}\) Id., Art. 253.

April - June, 2017
example of the exercise of this power by the Parliament– an example of a law to implement DTAs.

While Section 90(2) is an instance when the power under Article 253 has been exercised, Section 90(2A) of the Act is an instance of the exercise of powers under Article 246 along with Entry 97, presumably, of the Union List. A law made in pursuance of Article 246 has been used to override a law made in pursuance of Article 253. The issue is whether this is permissible. Thus, there is some uncertainty as to the scope of Article 253 that needs to be settled. Therefore, these questions as to the relation between Article 246 and Article 253 need to be addressed to answer the constitutional permissibility of a treaty override.

2. High Court Decisions

The question as to the constitutional validity of treaty override by means of a statute has come up before different High Courts over the last few years and has been answered differently. The High Court of Madras has held that such treaty override is constitutional, while the High Court of Delhi has held that it is unconstitutional. The High Court of Karnataka in an obiter has observed that it is constitutional. The High Court of Andhra Pradesh has found a third way out by holding that a treaty override is constitutional in some cases but is impermissible in others.

Before the High Court of Madras,61 the issue involved the constitutionality of Section 94A(1) of the Income Tax Act, 1961. Section 94A(1) allowed the Central Government to notify a country that was non-cooperative in terms of exchange of information under a bilateral treaty. Once notified, the terms of the DTAA would not be applicable to transactions between the two countries unless certain conditions were satisfied the provisions of the Income Tax Act, 1961 would apply. Therefore, the Court was asked to consider whether it was constitutionally permissible to override a DTAA by means of a domestic statute.

The assessee contended that the law-making power under Article 245 was subordinate to the power under Article 253 and hence, Section 94A was unconstitutional. The Court stated that the effect of Article 253 was only to remove the fetters placed on the legislative competence of Parliament by Articles 246, 249 and 250 and the lists mentioned in Seventh Schedule. It enabled the Parliament to make laws on any matter mentioned in any of the three lists so as to implement an international obligation. The non-obstante clause served that purpose. There was nothing in Article 253 to suggest that a law enacted under that Article would be placed on a higher pedestal than a law

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April - June, 2017
made under Article 246(1). In fact, the Court went to the extent to suggest that nowhere did the Constitution consider such a dichotomy.

An ancillary question before the Karnataka High Court was whether a retrospective amendment made by the Finance Act, 2012 would override the DTAA operating alongside the domestic law. The Karnataka High Court observed that in view of §90(2) of the Act, the provision that was more beneficial to the assessee would apply. However, the unilateral cancellation of a treaty was a sovereign power of the Parliament. The scope of legislation enacted subsequently, cannot be curtailed by the terms of a prior DTAA. The Court, however, did not discuss this position in greater detail. It said that because this issue was not specifically contended by the petitioners and was one that needed detailed discussion, it did not wish to express any further views on it.

Before the High Court of Delhi, the issue involved the applicability of an amendment made to the definition of ‘royalty’ under Section 9(1) (vi) of the Income Tax Act, 1961 by the Finance Act, 2012. The amendment was made with retrospective effect. In these cases, the DTAA also defined the term ‘royalty’. Effectively, the tax authorities sought to apply the amended definition in domestic statute over the definition in the treaty. As the definitions differed, benefits under the treaty would be denied. Thus, the question to be answered by this court was whether a provision in the DTAA could be superseded by an amendment made to the domestic statute.

The Court framed the question of whether an amendment made to a domestic statute can be read into a treaty. It stated that no amendment, whether retrospective or prospective, could be read in a manner that modifies the operation of the terms of an international treaty. Domestic law remains static for the purposes of a DTAA. It held said that while the Parliament may be supreme, it was “simply not equipped with the power to, through domestic law, change the terms of a treaty.”

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62 Id., ¶ 29.
63 Id., ¶ 30.
65 Notably, the questions before the High Courts of Delhi and Andhra Pradesh could also have been answered in this manner.
68 Id., ¶ 41.
69 Id., ¶ 50.
70 Id., ¶ 52 (This decision is likely to be used to challenge the application of GAAR to DTAA. The amendments, in fact, merely modified the Indian domestic law, but had a limiting effect.}

April - June, 2017
Before the High Court of Andhra Pradesh, there was a similar question. The Andhra Pradesh High Court followed the decision of the Canadian Supreme Court in *R. v. Melford* and said that once a law has been enacted under Article 253, every other law is subject to that law. A law made under Article 253 cannot be amended by a subsequent statute, which has been ordinarily made pursuant to the powers conferred under Article 246. The court said that this was necessary to maintain the sanctity of international obligations because otherwise, domestic law would routinely alter the country’s international obligations.

However, unlike the Delhi High Court, the court was not absolute in its opinion. It said that in case a law was enacted with a specific intention to amend the law made under Article 253, this would be permissible. In an obiter it observed that the introduction of §90(2A) was an instance of a law with a specific intention to amend a law made under Article 253 – a law that sought to override the effect of §90(2).

Consequently, there are three sets of opinions that come to the fore from the decisions of the High Courts. This uncertainty is likely to result in a challenge to the GAAR on grounds that it overrides DTAAs. Moreover, it is reasonable to suppose that the decision of the Delhi High Court and the principle embodied in the decision of the Andhra Pradesh High Court would be relied upon by those who seek to maintain such a challenge. The validity of such a challenge can be resolved by an analysis of Article 253 – the text and the purpose of the provision.

3. Examination of the Constitutional Scheme

As noted previously, the Parliament is conferred with the powers to make law by two separate means – Articles 245 and 253. When powers conferred by both these channels have been used to make two laws, the question to be answered is which of those laws prevails when they are inconsistent. In the event that the authority conferred is of a similar nature, both laws stand at the same pedestal and one has to resolve the inconsistency by means of statutory interpretation. In case it is not so, one has to identify which of the two powers is superior to the other and the law made in the exercise of the superior power

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74 Thus, under this approach, the Andhra High Court found that GAAR would withstand a constitutional challenge. However, we argue that while the outcome would be correct, the reasoning adopted to arrive at it is unsound. The next sub-section shall amply demonstrate our claim.
must prevail. For example, powers conferred upon Parliament by Articles 246(1) and 246(2) are at the same footing. Therefore, when one law is made on a subject matter contained in the Union List and another is made on a subject matter contained in the Concurrent List, the conflict is resolved by tools of statutory interpretation. The issue is whether powers conferred by Article 246 and Article 253 are also at the same pedestal. We contend that they are at the same pedestal by examining the effect of the *non-obstante* clause in Article 253 and the similar nature of legislative power under Articles 246 and 253.

a. Effect of the non-obstante clause in Article 253

Article 253 contains the phrase, “Notwithstanding anything in the foregoing provisions of this Chapter”. The *non-obstante* clause could mean that Article 253 prevails over Articles 245 and 246. On the other hand, it could mean that the restriction placed by Article 246(3) is removed by virtue of this phrase. Article 246(3) confers upon State Legislatures the exclusive powers to make laws with respect to subjects mentioned in the State List. The *non-obstante* clause in Article 253 would thus allow even the Parliament to make laws on these items in so far as they are meant to implement any treaty or other such international obligation.

One could contend that Article 245 vests the Parliament with legislative powers. Article 253 also does so. Therefore, the *non-obstante* clause could make the legislative powers under Article 253 prevail over those in Article 245. However, when the Constitution intended one statute to prevail over another, it made an explicit mention of the same as in Article 254.75 There is no such mention when it comes to Articles 253 and 245. Moreover, the powers conferred by Article 253 are also conferred by Entries 10, 14, 15 and 16 among others of List I of the Seventh Schedule. Therefore, in case Article 253 was to prevail over Article 245 by virtue of the *non-obstante* clause, it would lead to an absurd situation wherein laws on the same subject matter could also be superseded.

However, Article 253 uses the term “anything” after “Notwithstanding” and thus, it can be construed to remove the fetter placed by Article 246(3) as well as to prevail over Articles 246(1) and (2) and Article 245. Nevertheless, the *non-obstante* clause is with respect to the provisions of the Chapter. Part XI of the Constitution deals with the “Relations between

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75 Constitution of India, Art. 254(1) (It reads: “If any provision of a law made by the Legislature of a State is repugnant to any provision of a law made by Parliament which Parliament is competent to enact, or to any provision of an existing law with respect to one of the matters enumerated in the Concurrent List, then, subject to the provisions of clause (2), the law made by Parliament, whether passed before or after the law made by the Legislature of such State, or, as the case may be, the existing law, shall prevail and the law made by the Legislature of the State shall, to the extent of the repugnancy, be void.”).
the Union and the States"76 and Chapter I of this Part deals with “Legislative Relations”77 and to be more specific with “Distribution of Legislative Powers”.78 The overall scheme of the Chapter thus, is to deal with the working of federalism.79 When construed in this backdrop, the non-obstante clause only carves out an exception to the federal scheme and confers upon Parliament powers over subject items where the power has otherwise been conferred upon the State Legislatures. This can also be inferred from the debates in the Constituent Assembly.80

The Supreme Court, too, has interpreted Article 253 in this fashion. In Maganbhai Ishwarbhai Patel v. Union of India, the court said that the effect of Article 253 was that if a treaty or any other international instrument dealt with a subject within the competence of State Legislatures, the Parliament would have the power to make laws to implement these international instruments.81 This position of law was reiterated in State of W.B. v. Kesoram Industries Ltd.82 In addition to these landmark cases on Article 253, other cases, too, have not said that the non-obstante clause supersedes Article 245.83

b. Nature of Power under Articles 245 and 253

The premise of the analysis until now has been that the power conferred by both Articles 245 and 253 is in the nature of a legislative power. Alternatively, though, it could also be contended that the powers conferred by these two provisions on the same legislative body are different by nature. This

76 Constitution of India, Part XI.
77 Id.
78 Id.
79 M.P. Jain, INDIAN CONSTITUTIONAL LAW, 531 (6th edn., 2010).
80 The fact that Article 253 was intended to override Article 246(3), on the other hand, seems to be evident. When Items 14, 15 & 16 of List I of the Seventh Schedule were being debated, there were several amendments which sought to curtail the powers of the Parliament in so far as items in List II were concerned. Some members of the Constituent Assembly wanted that the Parliament be allowed to pass laws to implement international treaties on items in List II only with the previous consent of the States. They opined that this was important to prevent a usurpation of the legislative powers of the State. However, these amendments were negatived. The Constituent Assembly wanted to confer such powers upon Parliament. These debates were referred to by Mr. Krishnamachari when moving an amendment to Article 230 of the Draft Constitution. Therefore, the fact that Article 253 is meant to prevail over Article 246(3) is clear even from the Constituent Assembly (CONSTITUENT ASSEMBLY DEBATES, October 14, 1949, Speech by T.T. KRISHNAMACHARI, http://parliamentofindia.nic.in/ls/debates/vol10p7c.htm (Last visited on November 26, 2016)).
82 State of W.B. v. Kesoram Industries Ltd., (2004) 10 SCC 201, ¶ 238-239; See also State of W.B. v. Kesoram Industries Ltd. (“Article 253, thus, operates notwithstanding anything contained in Article 245 and Article 246.” The Court did not elaborate on this and went on to discuss the legislative competence of a State when the power under Article 253 had been exercised by the Parliament vis-à-vis an item in List II.).

April - June, 2017
contention could be supported by an analogy drawn with Article 368. While Article 368 confers certain ‘constituent powers’ on Parliament, Article 245 confers legislative powers on it. Like Article 368, Article 253 could be argued to confer power of a nature other than legislative power and thus, the *non-obstante* clause would signify that it prevailed over Article 245. This argument though has no textual basis. As mentioned previously, Article 253 also only confers the ‘power to make any law …implementing any treaty, agreement or convention’. It is at the same pedestal with Article 245. In fact, Article 253 finds a place in the Constitution perhaps only by means of abundant caution, to allow Parliament to not be curtailed by Article 246(3) when it comes to foreign affairs. The discussions in the Constituent Assembly on Article 253 give this impression. Moreover, they also seem to indicate that the framers did not intend the power conferred by Article 253 to be of a kind other than legislative power.

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84 There are two ways in which international law may come to become a part of municipal law- by incorporation and by transformation. The doctrine of incorporation says that any international law would also be a part of the domestic law of a state. On the other hand, the doctrine of transformation says that international law would become a part of the municipal law of a state only when it is specifically adopted by the state concerned (Malcolm Shaw, *International Law*, 140 (6th edn., 2008)). The Constitution of India has adopted the doctrine of transformation, and Article 253 is a manifestation of this adoption. Article 253 uses the phrase, “power to make any law… for implementing any treaty…” (emphasis supplied). No treaty, agreement, convention or decision taken at an international forum would become a part of municipal law in India unless it is adopted by means of a statute framed by Parliament (State of W.B. v. Kesoram Industries Ltd., (2004) 10 SCC 201, ¶495-498). Therefore, a power has been conferred upon Parliament to make such laws by Article 253 and concomitantly, discretion has been provided to decide whether or not the power must be exercised. Popularly, this arrangement is known as the dualistic system. This system has also been recognised by the Supreme Court in Jolly George Varghese v. Bank of Cochin, (1980) 2 SCC 360 : AIR 1980 SC 470 and in many other subsequent decisions. Thus, in addition to carving out an exception to Article 246(3), Article 253 also lays out the relation between international law and municipal law in India. There is nothing in the dualistic scheme adopted by Article 253 which may indicate that the law made to transform international law into municipal law is intended to prevail over other domestic laws.

85 In the Constituent Assembly, there was no debate on Article 253, namely, Article 230 of the Draft Constitution. In fact, the provision was spoken about only on a couple of occasions. One such incident was when an amendment was moved to the Article by Mr. T.T. Krishnamachari. The amendment sought to add the phrase, “or any decision made at any international conference, association or other body” to the article. When moving the amendment, he said that the phraseology would ensure that Parliament could sufficiently meet its international obligations (Constituent Assembly Debates, October 14, 1949, Speech by T.T. Krishnamachari, http://parliamentofindia.nic.in/ls/debates/vol10p7c.htm (Last visited on November 26, 2016)); Dr. Ambedkar described the power conferred under Article 230 as one covered by the subject of Foreign Affairs and one which was already conferred upon Parliament (Constituent Assembly Debates, November 18, 1948, Speech by Dr. B.R. Ambedkar, http://parliamentofindia.nic.in/ls/debates/vol7p8.htm (Last visited on November 26, 2016)); Constituent Assembly Debates to indicate that Article 253 was intended to prevail over Article 245.
B. TREATY OVERRIDE UNDER INTERNATIONAL LAW

A second way to make a case to show that Section 90(2A) is invalid is to explore the scheme of the inter-relation between international law and municipal law and to see whether any restriction on the legislative power of the Parliament can be culled out from any other provision of the Constitution. This question has been considered by the same High Court decisions discussed above. However, given that these positions are again diverse, we shall examine the normative position after examining the treatment of the question by these courts.

1. High Court Decisions

This aspect has had a considerable impact on the decision of the Delhi High Court. The Court observed that the provisions of the Vienna Convention on the Law of Treaties, 1969 (‘VCLT’) were universally accepted as a part of customary international law. Article 39 of the VCLT says that an amendment to a treaty may only be brought about by an agreement between the parties.86 The Court relied on this provision and said that unilateral amendments were categorically prohibited. It said that,

“States are expected to fulfil their obligations under a treaty in good faith. This includes the obligation to not defeat the purpose and object of the treaty.”87

According to the Court this was a principle rooted firmly in customary international law and could not be breached. Even our Constitution under Article 51(c) endorsed this principle and in light of this, the legislative powers of Parliament were limited.88 On the contrary, the Madras High Court said that the provisions of the VCLT and other such rules of international law did not influence the legislative powers of Parliament.89 Even the Karnataka High Court said,

“Unilateral cancellation of tax treaty through an amendment to the internal law subsequent to conclusion of the treaty is a recognized sovereign power. Subsequent legislation cannot be controlled by the agreement.”90

88 Id.
Yet again, there is a dichotomy and the same may only be resolved by an examination of the interplay between international law and domestic law.

2. Examination of international law

Many of the principles contained in the VCLT have been acknowledged as principles of customary international law.91 Article 26 of the VCLT embodies the principle of *pacta sunt servanda*, meaning that every treaty is binding upon the parties to the treaty and must be interpreted in good faith.92 By extension, a DTAA entered into by India is binding upon India and must be followed by India in good faith. However, it is now well settled that when a State does not act in accordance with its obligations under international law in its domestic sphere, its domestic position stays unaffected.93 The domestic position is not over-ruled by the international obligation. It is only under international law that the State will be held to be in breach. The decision of the Delhi High Court that India is under an obligation to not defeat the purpose and object of a treaty and that Parliament was not equipped to unilaterally amend the terms of a treaty is contrary to this settled position. Therefore, in case India is said to violate a DTAA due to GAAR, this still does not lead to the invalidity of §90(2A). It is only in international law that India will be said to have committed a wrong.

In such a scenario, the remedy too lies in international law. Articles 34, 35 and 36 of the Draft Articles on State Responsibility say that when a State commits an international wrong, the injured state may claim restitution, compensation or satisfaction as a remedy.94 When a State breaches international law by virtue of the enactment of a domestic statute, restitution is usually not claimed as a remedy. Domestic policies and laws are considered to be matters of national sovereignty and hence, there is a hesitation to seek a reversal of such laws and policies as a remedy. Sanctions,95 in the form of suspending treaty benefits or terminating the treaty, are the most common remedy.96 Therefore, a foreign state may at best reciprocate by terminating certain treaty benefits or claim compensation from India due to the enactment of Section 90(2A).

Moreover, Article 51 of the Constitution, despite what the Delhi High Court stated, does not affect this position. Article 51, which is contained in Part IV (Directive Principles of State Policy), says,

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93 SHAW, supra note 84, 133.
96 KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS, 69 (3rd ed., 2010).
“The State shall endeavour to – ...(c) foster respect for international law and treaty obligations in the dealings of organised peoples with one another…”97

To foster respect for international law and treaty obligations, it may reasonably be argued that the Indian State must itself respect international law and treaty obligations. It must abide by the obligations undertaken by it in treaties, agreements et al. However, in view of the fact that this provision is contained in Part IV, it is merely a policy directive and is not enforceable.98 Effectively, Article 51 is only a directive to minimise the commission of international wrongs. It does not embody any principle that can be a restriction on the legislative powers of Parliament. Therefore, even on this count §90(2A) may not be said to be constitutionally invalid.

Thus, the GAAR is likely to withstand challenges on the grounds of treaty override. However, this does not mean that its application to treaties is going to be free from uncertainty. This is especially true in the case of several of India’s new treaties, and old treaties that have been recently re-negotiated.99 These treaties, including the amended India-Mauritius treaty, contain clauses that seek to limit benefits of the treaty to genuine residents of the treaty countries. Effectively, these clauses, like the GAAR, seek to minimize tax avoidance. Investors would not be amiss to assume that transactions satisfying such clauses would not be affected by GAAR. However, this is not the case and there is great potential for conflict between the amended provisions and GAAR. Though the principle is uniformly applicable, the India-Mauritius treaty merits separate examination given its significance for foreign investment in India. The following chapter examines the application of GAAR to this treaty.

V. GAAR AND THE INDIA-MAURITIUS TREATY

In this chapter, we shall firstly examine, the nature of the amendments made to the India-Mauritius DTAA. In the transition period, certain transactions have been grandfathered while a Limitation of Benefits clause has been introduced for others. The second half of this part examines the application of GAAR to transactions covered by the Limitation of Benefits clause.

97 Constitution of India, Art. 51(c).
98 Jain, supra note 79, 1488-1489.

April - June, 2017
A. AMENDMENTS TO THE INDIA-MAURITIUS AGREEMENT

To stop base erosion from taking place as a result of the double non-taxation, the Treaty was finally amended in 2016 by way of a Protocol. The Protocol provides for capital gains tax to be levied in India, where the gains arise from the transfer of shares of an Indian company. However, this shall be introduced in a phased manner.

All investments made prior to March 31, 2017 have been grandfathered and shall continue to enjoy exemption on capital gains regardless of when they are sold. A transition period has been provided for from April 01, 2017 to March 31, 2019, during which the tax rate shall not exceed 50% of the prevailing tax rate in India. However, the benefit in the transition period is subject to satisfaction of a Limitation of Benefits clause. As per the clause, this benefit shall not be extended unless the assessee satisfies the ‘main purpose and bona fide business’ test and that it is not a shell/conduit company. While the former is a subjective question, an objective test has been prescribed to assess the latter. Subsequently, for shares bought in this period and sold after March 31, 2019 or bought thereafter, the capital gains tax rate applicable in India shall be levied.

The non-applicability of GAAR to grandfathered transactions is straightforward and therefore, unlikely to be a source of controversy. The

(a) it is listed on a recognized stock exchange of the Contracting State; or
(b) its expenditure on operations in that Contracting State is equal to or more than Mauritian Rs.1,500,000 or Indian Rs.2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.”)
103 The India-Mauritius Protocol grandfathers transactions made before April 1, 2017. Article 4 of the Protocol states that amendments with respect to capital gains shall apply only to shares ‘acquired on or after 1st April 2017’ (emphasis supplied). Consequently, for investments made prior to this date, capital gains through shares from Indian companies will be taxable in Mauritius alone. Moreover, the rules notified for GAAR state that it shall not apply to ‘any income accruing or arising to, or deemed to accrue or arise to, or received or deemed
next sub-part examines the application of GAAR to transactions covered by the Limitation of Benefits clause.

B. LIMITATION OF BENEFITS CLAUSES AND GAAR

1. The Introduction of Limitation of Benefits Clauses in Indian tax treaties

The Limitation of Benefits clause is a special anti-avoidance provision, which include ensuring treaty benefits are restricted to genuine residents of the other treaty country.\(^{104}\) Limitation of Benefits clauses may either be subjective – such as main purpose or bona fide tests – or objective – such as minimum investment requirements. The India-Mauritius treaty has both subjective and objective components.\(^{105}\) As most of India’s treaties focused on source-based taxation, rather than residence-based taxation,\(^{106}\) preventing treaty shopping was not a significant policy goal. However, following the controversy over the Mauritius DTAA that culminated in *Azadi Bachao Andolan*, several new and renegotiated treaties including those with UK, USA and Singapore and now finally, Mauritius have seen the introduction of Limitation of Benefits clauses.\(^{107}\)

2. GAAR to have effect notwithstanding Limitation of Benefits clauses

Given that the purpose of a Limitation of Benefits clause is to ensure that treaty benefits are limited to genuine residents of the other country, to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.’ (Rule 10U, Income Tax Rules, 1962.).

\(^{104}\) Other special anti-avoidance rules include tests to determine where the permanent establishment of a company is, who the beneficial owners of the company are and so on. All these tests primarily apply to determine the residence of companies in order to ensure that residents from third countries that are not parties to the treaty do not benefit. These tests have little applicability to natural persons because their residence is relatively easier to determine. A contemporary example of the difficulty of determining the residence of a company is seen in the dispute involving the tax liability of Apple in Ireland (See Vanessa Houlder, *Apple’s EU tax dispute explained*, The Financial Times August 30, 2016, https://www.ft.com/content/3e0172a0-6e1b-11e6-9ac1-1055824ca907 (Last visited on April 1, 2017)).


\(^{106}\) This is true of India’s treaties with the exception of Mauritius, Singapore, Cyprus and Netherlands.

the question is whether GAAR could be invoked nevertheless to pierce the corporate veil and to assess residence. The Shome Committee on the GAAR stated that the Limitation of Benefits clause should take precedence over the GAAR as it is a special law. As per the principle of interpretation, _lex specialis derogat legi generali_, the special law overrides the general. Consequently, in case of transactions covered by the Limitation of Benefits clause, GAAR should not apply.\(^{108}\) This is also standard practice in other jurisdictions that have GAAR.\(^{109}\)

However, there is a lack of certainty over the pre-eminence of Limitation of Benefits clauses in India given the fact that Section 90 (2A) contains a _non-obstante_ clause. It reads:

> “Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him”\(^{110}\) (emphasis supplied).

The purpose of a _non-obstante_ clause is to give overriding effect to certain provisions over others. They are typically employed when two sets of provisions are in contradiction to each other. The _non-obstante_ clause indicates which of the two must get precedence.\(^{111}\) As a result, Section 90(2), which allows for the treaty to apply instead of the Act to the extent it is more beneficial, is overridden by the Act in case the arrangement falls foul of GAAR. Thus, in case an arrangement is held to be impermissible under the terms of Chapter X-A, treaty benefits shall be denied to the assessee.

This lack of clarity was acknowledged by the Report of the Shome Committee on the GAAR. While it agreed that the GAAR should not apply in such cases as it is a general law, it stated that the given the _non-obstante_ clause the Act needs to be either amended or clarified through subordinate legislation.\(^{112}\) Thus, at present, GAAR shall override even those treaties that have a Limitation of Benefits clause.

The issue with this position of law is that an arrangement might fall foul of the GAAR inspite of satisfying the conditions of the Limitation

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\(^{108}\) Parthasarathy Shome Committee, _Final Report on General Anti-Avoidance Rules in Income Tax Act, 1961_, 49 (2012) (India’s DTAs also have other specific anti-avoidance rules (SAARs) such as the place of effective management for non-residents in Article 4 and restricted force of attraction rule under Article 7(1). Rules like these attempt to address a specific act of abuse. The Shome Committee recommended that for those specific aspects, the SAARs should have precedence over the GAAR. However, in current form, GAAR will override them. Comparatively, a Limitation of Benefits clause is of a more general nature than SAARs as it tries to address all the ways in which the treaty could be abused).

\(^{109}\) _Id._, 48 (For instance, Germany, Switzerland and Austria); See Klaus Vogel, _supra_ note 96, 71.

\(^{110}\) Income Tax Act, 1961, § 90(2A).

\(^{111}\) Vepa Sarathi, _Interpretation of Statutes_, 427-430 (5th ed., 2010).

\(^{112}\) Parthasarathy Shome Committee, _supra_ note 108.
of Benefits clause. This is because the scope of the GAAR is much broader than the Limitation of Benefits clause. The Limitation of Benefits clause in the India-Mauritius agreement contains an objective as well as subjective test. The subjective test states that treaty benefits may be denied if the assessee’s “affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention”. In case an arrangement is primarily for commercial purposes it would be permissible and the fact that it incidentally results in tax benefits would be immaterial.

On the other hand, this would not be the case under GAAR. Section 96(2) of the Act states that:

“An arrangement shall be presumed, unless it is proved to the contrary by the assessee, to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.” (emphasis supplied)

Even if a part of the arrangement was designed to obtain a tax benefit, it would be hit by GAAR. While the primary purpose of the entire arrangement may be commercial, the arrangement could be presumed to be impermissible. Evidently, arrangements in consonance with the Limitation of Benefits clause may also fall afoul of GAAR.

Moreover, the effect of an arrangement not satisfying the Limitation of Benefits clause would only mean that the assessee concerned would not be entitled to avail the tax benefits under the treaty. On the other hand, in case the arrangement is found to be impermissible under GAAR, it could also mean that the arrangement is disregarded or re-characterized or is considered as never having been entered into. It could also mean that the accruals, expenses, deductions or reliefs as provided in the arrangement are reallocated. Thus, the repercussions would extend beyond a mere tax liability and would have serious implications on international transactions even though

113 Most Limitation of Benefits clauses contain only objective tests. Subjective tests are usually found in treaties entered into by U.S.A. There is a growing trend to include objective tests across the world (See Gosain, supra note 107).


116 Supra Part III.

April - June, 2017
they are in compliance with the measures laid down by the treaty to arrest treaty-shopping.

3. The Canadian Experience

It is useful, at this point, to examine the interplay between GAAR and special anti-avoidance rules in other jurisdictions. Roughly seventeen jurisdictions have enacted provisions similar to GAAR over the past few decades. In about half of these jurisdictions, GAAR can override the treaty provisions. Of these, Canada has a robust network of DTAAs. It also has a GAAR with a structure to that in India. Moreover, since it was introduced in 1988, there are a few Canadian cases dealing with the interplay between GAAR and DTAAs. The application of GAAR to cross-border transactions under DTAAs in Canada can provide a useful precedent for India.

It is important to note that in 2005, the Canadian Income Tax Act was amended to explicitly state that GAAR could override treaty provisions. However, GAAR has seen very limited application in such cases, with courts largely deferring to the provisions of the treaty.

For instance, in Garron Family Trust v. R., (‘Garron’) the Tax Court of Canada held that the treaty cannot be said to have been abused in case the residence has been established as per the special anti-avoidance rule contained in the treaty. In Canada, a transaction is found to be violative of GAAR if it passes a three-step test: first, there must have been a tax benefit; second, the benefit must have arisen in an avoidance transaction, that is, the main purpose of the transaction should be the tax benefit; and third, the avoidance transaction must be found to be abusive of the treaty or statute, that is, it should violate

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118 Id., 32-85.
119 Id., 38-41 (For instance, some countries have judicially developed tests (USA) or a series of specific rules that perform the same function as the GAAR (Russia)).
120 Budget Implementation Act 2004 (No 2), 2005, §§ 52 & 60 (Canada); RMM Canadian Enterprises Inc. v. R., (1998) 1 CTC 2300 (The Court stated: “It would be a surprising conclusion that Canada, or indeed any of the other countries with which it has tax treaties, including the United States, had intentionally or inadvertently bargained away its right to deal with tax avoidance or evasion by residents of treaty countries in its own domestic tax laws. It would be equally surprising if tax avoidance schemes that are susceptible of attack under either general anti-avoidance provisions or specific anti-avoidance rules, if carried out by Canadian residents, could be perpetrated with impunity by non-residents under the protection of a treaty. That is not what treaties are for.”)
However, the lack of authorities cited in arriving at this conclusion meant that the authority of this decision was questionable; See DANIEL SANDLER, TAX TREATIES AND CONTROLLED FOREIGN COMPANY LEGISLATION: PUSHING THE BOUNDARIES 200 (2nd edn., 1998).
121 Garron Family Trust v. R., 2009 TCC 450.
the object or purpose of the benefit under the relevant treaty or statute.\textsuperscript{122} In \textit{Garron}, while there was a tax benefit that arose out of an arrangement made primarily for obtaining a tax benefit, the application of GAAR failed the third step. The Court held that the transaction was not abusive because the selection of the treaty or the reason for its selection is immaterial to determine abusive-ness.\textsuperscript{123} Only the manner of its use is material. Thus, the assessee in this case only needed to establish that it was a resident of the other party to the treaty.

In India, on the other hand, the presumption against the assessee under GAAR would arise as soon as it was shown that a treaty was selected to avail a tax benefit. It is immaterial if the main purpose was genuinely to do business and not to avail a tax benefit. It is also immaterial if the transaction or arrangement is not an instance of abuse as per the treaty.\textsuperscript{124}

In another Canadian case of \textit{Antle} v. R., the party was held liable under the GAAR as they were found to have violated treaty provisions.\textsuperscript{125} An argument put forth by the respondent was that the treaty should be read to inherently contain an anti-avoidance provision and thus, it excludes the application of GAAR.\textsuperscript{126} The response of the court to this argument is informative for our examination of the interplay between Limitation of Benefits clauses and GAAR. The court stated that the treaty could not be read as containing such an inherent principle because there was no Limitation of Benefits clause. In the absence of such a provision, there was no basis to read an anti-avoidance principle into the treaty.\textsuperscript{127} This, in a sense, implies that the presence of a Limitation of Benefits clause could have excluded the application of GAAR.

Canadian courts have been hesitant to apply the GAAR where tax benefits were obtained after complying with the special anti-avoidance rules laid down in the treaty. They have accepted such benefits as legitimate instances of tax-planning. On the other hand, in India, if a tax benefit arises out of a treaty, GAAR would apply regardless of the fact that it is permitted as per the terms of the treaty. Merely the existence of a tax benefit would attract the presumption under the GAAR, even though the Limitation of Benefits clause is satisfied. Thus, the Indian position risks rendering the Limitation of Benefits clause and any other special anti-avoidance rule redundant, as GAAR shall apply regardless.

\begin{footnotesize}
\textsuperscript{123} Garron Family Trust v. R., 2009 TCC 450.
\textsuperscript{124} Income Tax Act, 1961, § 96(2).
\textsuperscript{125} Antle v. R., 2009 TCC 465.
\textsuperscript{126} This has been done in jurisdictions like Switzerland. \textit{See} Swiss Supreme Court decision 2A.239/2005.
\textsuperscript{127} Antle v. R., 2009 TCC 465.
\end{footnotesize}
4. Disadvantages of GAAR applying where there is a Limitation of Benefits Clause

In case the transaction is held to be impermissible under the India-Mauritius DTAA, the treaty benefits would be denied.128 As the capital gains tax rate arising out of alienation of shares from 2017 to 2019 in the case of Mauritius is fifty per cent that of the rate applicable in India,129 it would double the tax liability. Equally important is the fact that the Indian tax authorities have a poor track record.130 The procedure prescribed for GAAR under §144BA of the Act is long-winded.131 Even if no additional liability is incurred, investors are afraid of the transaction costs involved in terms of time and resources in getting involved in a very arduous process.132 This is in contrast to Canada, the United Kingdom and several other jurisdictions where a Panel must approve the applicability of the GAAR.133 Consequently, Canada has seen relatively little litigation over GAAR, although it is now increasing.134

Further, it is to be noted that an assessee would assume that they are eligible to obtain benefits under the treaty on obtaining a TRC because a TRC would only be issued when the Limitation of Benefits clause was satisfied.135 GAAR, on the other hand, would apply after the stage of filing returns.136 Thus, the applicability of GAAR to treaties that have a Limitation of

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130 Ganguli, supra note 11; Krishnan, supra note 11; Nayak, supra note 11.
131 Income Tax Act, 1961, § 144BA ("When an Assessing Officer considers it necessary to declare an arrangement to be impermissible, he may make a reference to the Commissioner. In case the Commissioner concurs, he shall provide the assessee with an opportunity to be heard. If he is not satisfied with the explanation put forth by the assessee, he shall then refer the matter to an Approving Panel within sixty days of the reference. The Approving Panel then has six months to hear both the assessee and the Assessing Officer and issue necessary directions. On receipt of such directions, the Assessing Officer shall then complete the proceedings.").
133 EY, supra note 118, 13.
135 See Form 10FA under Income Tax Rules, 1961, Rule 21AB (One of the questions to be answered in this form is on what basis is residency being sort. The Limitation of Benefits clause requirements would have to be satisfied to answer this question).
136 Income Tax Act, 1961, §144BA (The application of the GAAR is at the stage of assessment or re-assessment).
Benefit clause would create considerable confusion and investors would not be certain of whether they are eligible for tax benefits even after obtaining a TRC. Naturally, this would have a significant impact on investor confidence. These fears are evident from two prominent examples- Vodafone and Apple- cases where tax benefits were denied after several years of continued business practices under the treaty. In the first, tax liability amounted to Rs. 12,000 crore, while in the second it amounted to almost $14 billion. Clearly, re-opening several years’ worth of tax liabilities can result in enormous liability and this can become even more common with the introduction of GAAR.

Therefore, there is a need to ensure that GAAR does not apply at least to those treaties that have Limitation of Benefits clauses. A clarification must be issued in the form of a notification or an amendment, as was recommended by the Shome Committee. This clarification could be in the form of a proviso or an additional sub-section which states that GAAR shall not apply to treaties that have a Limitation of Benefits clause. For the sake of abundant caution, a list of treaties can be specified by way of delegated legislation.

From the perspective of the revenue though, an obvious concern is the loss of revenue that would ensue from excluding such transactions from the scope of GAAR. This argument has also been raised in Canada in *Garron Family Trust v. R.* In that case, the Court said that the loss of revenue does not make legitimate tax planning an act of abuse. If a transaction satisfies the special anti-avoidance rules such as limitations of benefits clauses, any tax benefits accruing nonetheless cannot be said to be instances of abuse. A validly availed tax benefit has the sanction of the law and thus, cannot be said to be a case of loss of revenue. In India, the purpose of the Limitation of Benefits clauses is essentially the same as the GAAR, that is, to prevent avoidance of taxes through treaty shopping. Cases where tax benefits would be denied by the Limitation of Benefits clause would, more often than not, also be hit by the GAAR. In case the base erosion is still more than what was sought to be arrested, the Limitation of Benefits clause may be modified to cover a larger number of transactions.

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139 *Garron Family Trust v. R.*, 2009 TCC 450.
140 *Id.*
141 As argued previously, Limitation of Benefits clauses can be objective as well as subjective. Objective clauses, such as those found in treaties entered into by the United States of America are argued to be stricter than subjective clauses such as ‘main purpose’ tests. While an example of this can be found in the India-Mauritius DTAA, which has a listing and minimum investment requirement, it can also take other forms such as stipulating that a minimum number of shareholders must be from the same country. Similarly, the Shome Committee stated that rather than applying GAAR, Limitation of Benefits clauses should be tightened if the need arises; *See Parthasarathy Shome Committee*, *supra* note 109, 48.
VI. CONCLUSION

Fears over arbitrary application of GAAR and the vague framework thereunder mean that a challenge to it is imminent. Transactions with low-tax treaty jurisdictions are likely to undergo heavy scrutiny. Consequently, one of the grounds on which this challenge would be made is that treaties cannot be over-ridden by domestic legislation. Contrary High Court decisions provide for fertile ground for such a challenge. In fact, the rationale laid down by the Delhi High Court would support such a challenge. However, Articles 253 and 245 of the Indian Constitution stand on the same footing. The effect of the non-obstante clause under Article 253 is only to remove the fetters of federalism placed by Article 246(3). It certainly does not give either Article precedence over the other. As a result, a constitutional challenge on these grounds is likely to fail. This is also supported by the decision of the Madras High Court. Nothing under international law would result in the invalidation of GAAR either.

On the other hand, the application of GAAR to DTAAs can be prevented on the ground that the treaties contain Limitation of Benefits clauses. As these clauses comprise a special law, they should take precedence over the GAAR. Canadian courts have adopted this position. However, in current form, the non-obstante clause in §90(2A) would mean that both apply simultaneously. Transactions might be affected by GAAR even though they satisfy the requirements of the Limitation of Benefits clause because the former is broader in scope. Not only would individual assessees be denied treaty benefits and be asked to pay higher taxes, they would also be subject to several other consequences specified in the statute. This is likely to have a negative impact on investor confidence. Even if they are not subsequently taxed, investor confidence will also be dented by scrutiny under the GAAR because they would be made to undergo lengthy proceedings in spite of having complied with the Limitation of Benefits clauses. Moreover, transactions covered by these clauses will not be able to avail any of the treaty benefits and will be taxed accordingly. Hence, it is unlikely that the change proposed will lead to any loss of revenue.

Thus, it is imperative that the Government of India addresses this issue by amending the statute to state that GAAR shall not apply to treaties that have a Limitation of Benefits clause and for the sake of abundant caution, specify a list of these treaties by way of delegated legislation.