

ANTI-AVOIDANCE MEASURES

T.P. Ostwal* and Vikram Vijayaraghavan

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* Senior Partner of M/s. Ostwal Desai & Kothari; Member of the Technical Advisory Group (E-Commerce) of OECD Paris.

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I. TAX AVOIDANCE: AN INTRODUCTION

A. *Tax Avoidance v. Tax Evasion*

Tax avoidance has various definitions in legal rulings and academic literature:-

- a) Justice Reddy¹ calls it the “art of dodging tax without breaking the law”;
- b) Black’s Law Dictionary states that tax avoidance is the “minimization of one’s tax liability by taking advantage of legally available tax planning opportunities”;
- c) The Organization for Economic Co-operation & Development (OECD), terms “tax avoidance as an arrangement of a taxpayer’s affairs that is intended to reduce his liability and that although the arrangement could be strictly legal is usually in contradiction with the intent of the law it purports to follow”;²
- d) The European Court of Justice (ECJ) views tax avoidance as “artificial arrangements aimed at circumventing law”;
- e) The Carter Commission Report (Canada, 1966) states that tax avoidance is “every attempt by legal means to reduce tax liability which would otherwise be incurred by taking advantage of some provision or lack of provision in the law”;³
- f) The landmark *Helvering v. Gregory*⁴ judgment says “any one may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

The common theme amongst all the definitions of tax avoidance is that it is a “grey area” of exploiting, albeit legally, the tax laws of countries to maximum benefit. There is often a thin line between acceptable tax avoidance, also known as tax planning and unacceptable tax avoidance.

¹ *McDowell v. Commercial Tax Officer*, (1985) 154 ITR 148 (Supreme Court of India) [hereinafter “*McDowell*”].

² Glossary of Tax Terms, http://www.oecd.org/document/29/0,3343,en_2649_34897_33933853_1_1_1_1,00&&en-USS_01DBC.html.

³ Royal Commission on Taxation (Carter Commission), 1966, Canada.

⁴ *Helvering v. Gregory*, 69 F.2d. 809 (2nd Cir. 1934).

Tax evasion on the other hand is the “**unlawful escaping of tax liabilities.**”⁵

A distinction has to be made between **tax avoidance** and **tax evasion**; there is no thin line but a gulf between the two. The latter is clearly illegal; the former is legal. Another way to look at it is that tax avoidance is a breach of social contract whereas tax evasion is a crime.

B. Tax Avoidance Techniques – General Theory

There are four basic tax avoidance techniques practiced,⁶ though numerous variations and subtleties exist:

- a) Deferred payment of tax liability
- b) Re-characterization of an item or income or expense to tax at a lower or nil rate
- c) Permanent elimination of tax liability
- d) Shifting of income from a high-taxed to a low-taxed person

In practice these techniques are carried out using the following methods:

- a) Use of tax Treaties for related-party transactions (i.e., “Treaty Shopping”)
- b) Use of international tax shelters through artificial intermediary companies (i.e., “CFC”)
- c) Excessive use of debt over equity (i.e., “Thin capitalization”)
- d) Non-arm’s length transactions (i.e., “Transfer Pricing manipulation”)
- e) Transfer of residence
- f) Branch entities
- g) Use of Tax Havens

The bottom line is that all tax avoidance techniques take advantage of inconsistencies and discontinuities in the tax systems through various tax arbitrage techniques. We will look at how these techniques are used in more detail while discussing their counter-measures in later sections of this paper.

⁵ Royal Commission on Taxation of Profits and Income, UK, 1955 [hereinafter “*Radcliffe Commission*”].

⁶ R. Rohatgi, *Anti-Avoidance Measures*, in BASIC INTERNATIONAL TAXATION VOLUME II: PRACTICE OF INTERNATIONAL TAXATION 141 (2000).

II. SOURCES OF ANTI-AVOIDANCE MEASURES

A. *Introduction*

Given these tax avoidance techniques, it is illustrative to see how governments around the world react to this problem.

- a) **Legislative solutions:** Most governments seem to rely on anti-avoidance statutes which are passed by their legislatures. Such legislations can be broken down into two categories and their distinction is very important as we will see in later sections of this paper:
 1. Specific anti-avoidance rules targeted at specific tax avoidance measures [hereinafter “SAAR”]
 2. General anti-avoidance rules which are, as the name suggests a catch-call system for tax avoidance [hereinafter “GAAR”]
 3. Bilateral measures are also pursued through treaties or Double Taxation Agreements [hereinafter “DTAAs”]
 - i. This can be done via various clauses inserted in them. Examples of this include the “Beneficial Ownership” and “Limitation on Benefit” clauses one finds in many Treaties.
 - ii. The treaties may have specific anti-treaty shopping rules
 - iii. The use of the Articles pertaining to Exchange of Information in Treaties are also used to counter tax avoidance
- b) **Judicial solutions:** The Courts across the world have been instrumental in evolving and developing various judicial doctrines to curb tax avoidance.
- c) **Administrative solutions:** To figure out tax avoidance has taken place and to get information on such practice is paramount; administrative measures are a useful tool for governments to both curb and detect tax avoidance practice.

B. *Judicial anti-avoidance measures*

The Courts may take either a literal, i.e., strict view or purposive view towards statutory interpretation. Dozens of Courts the world over have played an important role in developing SAAR and GAAR principles and laws. The two guiding principles⁷ in judicial anti-avoidance are:

⁷ Frederik Zimmer, Form and Substance in Tax Law (IFA Cahiers, Vol 87A, General Report 2002); *See also supra* note 7; IFA Online, <http://www.ifa.nl>.

- a) Business purpose rule (motive test)
- b) Substance over form rule (artificiality test)

(i) The “Business Purpose” rule

The “business purpose rule” is simple; it says that a transaction must serve a business purpose, i.e., commercial justification, other than tax avoidance. Mere tax advantage cannot be the sole or main business purpose. In the landmark judgment *Gregory v. Helvering*⁸ the U.S. Supreme Court held that a corporate reorganization under the law solely for tax purposes did not qualify for tax benefits.

It should be mentioned that business purpose is seldom defined in the statutes; Courts simply adopt a common-sense view. There are several dozen U.K. rulings which have attempted to define “business purpose”.

There are some interesting questions one can ask when it comes to business purpose; should the business purpose always be financial? Is defence from a takeover a justified business purpose? Another question is, is the motive distinct from purpose; does the purpose refer to the ultimate objective or aim or does it mean the subjective motive of the taxpayer? The answer to these questions is left as a puzzle for the reader to solve; suffice to say one could refer to *Inland Revenue Commissioner v. Brebner*⁹ and *Mallelieu v. Drummond*.¹⁰

(ii) “Substance v. Form”

The substance versus form principle is wider in scope than the business purpose rule; the 1987 OECD report defines it as “the prevalence of economic or social reality over the literal wording of legal provisions.”

Substance versus form makes for fascinating debate; when does one stop literally interpreting and start piercing the veil? There is no easy answer for this. Whatever be the case, it would be wise for any legal student or practitioner to understand the various faces of “substance v. form” as listed below:

a) Legal v. Economic Substance

This applies to situations where due to the legal form used for the transaction a taxpayer has the real economic power over the taxable income without the tax liability.

⁸ *Helvering v. Gregory*, 69 F.2d 809 (2nd Cir. 1934).

⁹ *Inland Revenue Commissioner v. Brebner*, [1967] 2 A.C. 182 (H.L.) (U.K.).

¹⁰ *Mallelieu v. Drummond*, [1983] S.T.C. 665 (H.L.) (U.K.).

A famous case in this regard is the *Duke of Westminster* case.¹¹ In this case the taxpayer executed tax-deductible deeds of covenants to pay selected employees without affecting their non-deductible wage entitlements. Under separate non-contractual agreements with the employees, it was assumed that they would not expect to be paid their existing wages but be content with payment under the covenant plus such additional amount as required to increase their income to their current salary. The House of Lords held that they must be regarded as covenanted payments and that they were entitled to deduct them. In short, the Court accepted the legal form of covenanted payments although they could be treated in substance as the economic equivalent of wage.

Another important case regarding economic substance is *Aiken Industries v. Commissioner*.¹² The short summary of this case is as follows: Mechanical Products Inc. (Aiken's predecessor) raised debt from an Ecuadorian corporation and issued promissory notes; the Ecuadorian corporation then exchanged these promissory notes for new promissory notes issued by Industrias, a Honduran company. Aiken repaid the debt and interest to Industrias, which in turn repaid its debt along with interest to the Ecuadorian corporation. Revenue contended that the entire structure was devised solely to avoid tax since interest payments to Industrias would not be eligible to tax withholding under US-Honduras Treaty (DTAA). The Court *agreed* with Revenue and held that Aiken, the successor of Mechanical Products, was liable for withholding taxes on interest paid.

One more landmark case relating to economic substance is *Northern Indiana Public Service Company v. Commissioner* [hereinafter "*Northern Indiana Public Service Company*"].¹³ The short summary is as follows. Northern Indiana USA intended to raise debt in Europe where interest rates are relatively lower; for this a subsidiary was set up in Netherlands to borrow from European bond holders. The terms and two notes were different and there was a small spread at the Dutch subsidiary level. Revenue contended that Dutch subsidiary was set up to avoid tax. The Court *disagreed* with Revenue saying financing was not with related parties and Dutch subsidiary had profit motive from the start.

¹¹ *Duke of Westminster v. Commissioner of Inland Revenue*, [1936] 1 A.C. 19 (H.L.) (U.K.).

¹² *Aiken Industries v. Commissioner*, 56 T.C. 925 (1971) (U.K.).

¹³ *Northern Indiana Public Service Co v. Commissioner*, 105 T.C. 341 (1991).

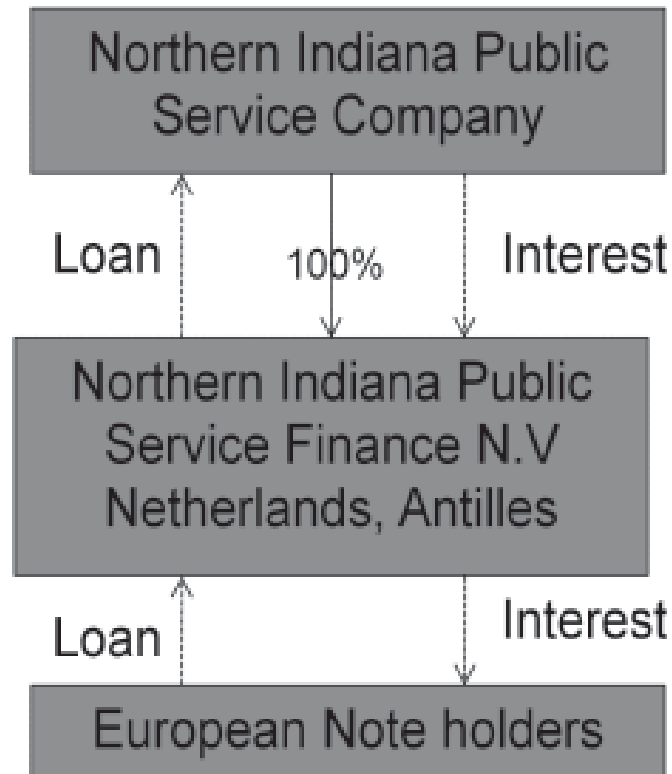


Figure 1: Northern Indiana Public Service Company case

A very recent case on this principle is that of *Jade Trading v. United States*.¹⁴ This case involved a tax shelter designed to produce large, artificial, i.e., noneconomic losses for tax purposes. The tax shelter involved 4 steps:

- Investment in Foreign Currency
- Contribution to a Partnership
- Partnership Investments
- Termination of Partnership Interests

The overall scheme:

- Investor first simultaneously purchased a European-style call option and sold a European-style call option.
- The investor next contributed the purchased and sold options to a partnership.

¹⁴ *Jade Trading LLC v. United States*, United States Court of Appeals for the Federal Circuit, 2008-5045 dated Mar. 23, 2010.

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- The investor eventually exited the partnership, received an asset with a claimed high-basis and low-value and then sold that asset to generate a tax-loss.

A tax loss was anticipated because, at the time of the facts giving rise to the case, an investor's basis in a partnership was ordinarily not decreased by the amount of a contingent liability contributed to or assessed by a partnership. The IRS held that the Jade partnership should be disregarded and all transactions engaged in by Jade should be treated as being engaged in directly by the purported partners. Both the Court of Federal Claims and the United States Appeals for the Federal Circuit upheld that the contribution of the spread transaction, via euro call options, to Jade was a transaction that lacked economic substance and affirmed the denial of Jade's petition (Emphasis Supplied).

b) Sham Transactions

In a sham transaction, they (the 'tax avoiders') give effect to a transaction, which they do not carry out, or do not intend to carry out or is a cover up for another transaction or relationship. A sham transaction essentially conceals the true nature or reality of a transaction that exists in form only. In short, the legal form is retained but the underlying substance is not genuine in law.

A landmark judgment regarding sham transactions is the *Knetsch* case.¹⁵ In this case, the taxpayer borrowed money at 3.5% to make a return of 2.5% from an investment in annuity issued by insurance company. Investment income was taxed at lower capital gains rate and the interest payments were fully deductible for tax purposes. The US Supreme Court treated the transaction as a sham and disallowed the interest paid on the loan. It was held that there was "nothing of substance to be realized beyond a tax deduction."

c) Doctrine of the Label ("wrong characterization")

In this method, parties use incorrect labels to classify or characterize a transaction or relationship for tax purposes.

A relevant case in this regard is the *Ridge Securities* case,¹⁶ where the Court rejected a loan with interest at over 400% per annum as a loan transaction.

¹⁵ *Knetsch v. United States*, 364 U.S. 361 (1960).

¹⁶ *Ridge Securities v. IRC*, (1962) 44 T.C. 373 (Ch.D) (U.K.).

In *Council of India* case,¹⁷ the Court rejected a purchase consideration described as an annuity payable over 47 years.

In the *Vestey* case¹⁸ the taxpayer had agreed to sell his shares at a consideration payable over 125 yearly instalments and treated the entire price as a capital receipt.

d) *Step-transaction doctrine*

Certain countries (like USA, UK, Japan and Canada) regard a series of connected transactions as a single transaction under the “substance v. form” principle.

In a “step transaction”, the intermediate steps in a chain of preordained, even if bona fide, transactions may be disregarded and several related transactions may be treated as a single composite transaction. Alternatively, a single transaction may be broken into distinct steps too to determine its tax acceptance.

It was observed in *McDonald's* case¹⁹ that “purely formal distinctions cannot obscure the substance of the transaction.”

An important case law in step-transaction is the *W.T. Ramsay* case²⁰ where the taxpayer made a large capital gain on the sale of a farm. To offset this, he entered into a series of separate share and loan transactions which generated both a non-taxable gain and fully allowable loss. The multi-step transactions as a whole were circular and self-cancelling. The taxpayer hence began and ended in the same financial position and still claimed a tax loss. The House of Lords disallowed the loss as fiscal nullity since the taxpayer had made no real financial loss and thereby established the “Ramsay doctrine” (doctrine of fiscal nullity).

Another case related to step transaction is *Gregory v. Helvering*²¹ where the taxpayer attempted to avoid dividend tax through a tax free corporate reorganization.

A much referred judgment related to step transaction is the famous *Furniss v. Dawson* case.²²

¹⁷ Council of India v. Scobie, 4 T.C. 618 (UK).

¹⁸ Vestey v. IRC, (1949) 40 T.C. 112 (Ch.D) (U.K.).

¹⁹ McDonald's Restaurant of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

²⁰ W.T.Ramsay Limited v. Inland Revenue Commissioner, (1981) 54 T.C. 101 (H.L.) (U.K.)

²¹ Helvering v. Gregory, 69 F.2nd 809 (2nd Cir. 1934).

²² Furniss (Inspector of Taxes) v. Dawson D.E.R., [1984] A.C. 474 (H.L.) (U.K.).

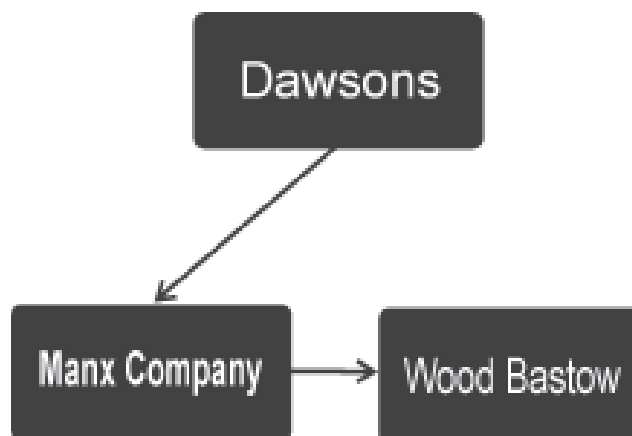


Figure 2: Furniss v. Dawson case overview

The short summary of this case is that Dawson decided to sell shares to Wood Bastow for £152,000. There was a deferral of capital gains by the following steps-

- Incorporation of Manx, a company
- Contribution of shares worth £152,000 in return for shares of Manx (tax-free transaction)
- Sale of shares by Manx to Wood Bastow for £152,000

The Court applied the Ramsey doctrine and imposed direct tax on sale & disallowed capital gains deferral.

It is interesting to note that the Courts in England have shown proclivity towards moving away from the Ramsey doctrine in subsequent decisions like *Craven v. White*,²³ *Macniven v. Westmoreland Investments Ltd.*,²⁴ *Barclays Mercantile Business Finance Ltd. v. Mawson*,²⁵ *Inland Revenue Commissioner v. Scottish Provident Institution*,²⁶ etc. The interested reader may take this up for further research.

e) Piercing the Corporate Veil

The piercing of the corporate veil is one of the most debated topics today in corporate circles.

²³ *Craven v. White*, (1988) 3 WLR 423 (H.L.) (U.K.).

²⁴ *MacNiven v. Westmoreland Investments*, [2001] S.T.C. 237 (H.L.) (U.K.).

²⁵ *Barclays Mercantile Business Finance Ltd v. Mawson*, [2005] S.T.C. 1 (H.L.) (U.K.).

²⁶ *Inland Revenue Commissioner v. Scottish Provident Institution*, [2005] S.T.C. 15 (H.L.) (U.K.).

The classic case for veil piercing is *Salomon v. Salomon*²⁷ where Salomon converted the business to a limited liability corporation when it was doing well. The business then floundered and went into liquidation. The question was ‘what was the true intent behind the conversion of the business?’ The House of Lords ruled that the company had been validly formed and in the famous words of Lord Macnaghten, “The company is at law a different person altogether from the subscribers to the memorandum of association...” On this basis, the court upheld the conversion of business as bona fide.

Another classic in common law veil piercing is *Adam v. Cape Industries*.²⁸ Synopsis of the case is that Cape was a large MNC based in England and in the asbestos industry. NAAC (Cape’s North-American subsidiary) had damages claimed by its employees in Texas due to asbestos-related illnesses. NAAC was liquidated and activities continued by new entity called CPC. Fact is that CPC was set up with financial support from Cape and operated in same premises with same employees as NAAC. However CPC was controlled via a Luxembourg agency of Cape called AMC (i.e. Cape → AMC → CPC). When fresh damages were claimed by employees, Cape refused to appear before American Courts saying it had no interests in America anymore and that AMC (its agency) came between CPC and Cape. The Courts sided on the side of Cape Industries saying the corporate veil cannot be lifted. However in coming to their decision, most importantly, the Courts went into an analysis on the three possible grounds for piercing, i.e., fraud, agency and the single economic unit theory.

An interesting Indian case related to corporate veil piercing in Company Law is the *Wood Polymer* case.²⁹ In this case, the company asked for grant of sanction of scheme of amalgamation under section 391(2) of the Companies Act, 1956. The scheme of amalgamation involved:

- a) Amalgamation of the transferor-company (Bengal Hotels Pvt. Ltd., a private limited company) with the transferee-company (Wood Polymer, a public limited company) along with the dissolution of transferor-company without winding up.
- b) According to the official liquidator’s report, the transferor-company (Bengal Hotels) was merely created to facilitate the transfer of “Avenue House”

²⁷ *Salomon v. Salomon & Co.*, [1897] A.C. 22 (H.L.) (U.K.).

²⁸ *Adams v. Cape Industries plc*, [1990] Ch. 433 (C.A.) (U.K.).

²⁹ *In re: Wood Polymer Limited* (1977), 109 ITR 177 (Guj.) (High Court of Gujarat).

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immovable property (belonging to the transferor-company's parent, DOC Ltd.) to the transferee-company (Wood Polymer) so as to avoid the payment of capital gains tax, which would otherwise have been payable under section 45 of the Income Tax Act, 1961.

- c) In order to avoid this capital gains tax, the transferor-company was floated and transferor-company availed of the benefit enacted in section 47 of the Income Tax Act.

The Court looked at relevant sections of the Companies Act and held that the Court is *not* merely a rubber stamp in scrutinizing a scheme of amalgamation. The following questions were also examined in detail by the Court:

- a) What was the legislative intent in introducing the second proviso to section 394 of the Companies Act?
- b) What is the ambit, scope and outer periphery of the concept of 'public interest' as envisaged in the second proviso?
- c) Is the disclosed purpose put forth by the companies who have moved the Court for sanction of merger/amalgamation, relevant consideration for the Court or *could the Court probe and go behind the apparent purpose and ascertain the real purpose* and take into consideration that purpose, so as to reach a conclusion that for such a purpose the Court would not permit its process to be utilized if the purpose is shown to be one which is opposed to public interest? (Emphasis Supplied)
- d) If, *except for the tax benefit, no other purpose for merger/amalgamation* is disclosed or on probing, tax avoidance appears to be the major and only purpose for the scheme, could it not be said that the purpose is such that *Court should not sanction the scheme* on the ground that it is opposed to public interest? (Emphasis Supplied)
- e) Should the Court by its process facilitate avoidance of tax, even if it can be said that avoidance is legal and cannot be styled as tax evasion?

The Gujarat High Court looked at various decisions of the Indian and English Courts and came to a decision that the said scheme of amalgamation could not be sanctioned. It held that:

The scheme of amalgamation must have some purpose or object to achieve...the purpose and the only purpose appears to be to acquire capital asset of DOC Ltd. through intermediary transferor-

company...it can never be said that the affairs of the transferor-company sought to be amalgamated, created for the sole purpose of facilitating transfer of capital asset, through its medium, have not been carried out in a manner prejudicial to public interest...the Court *will not lend its name its assistance to defeat public interest, namely tax provision.*

...It must be confessed that it is open to a party so as to arrange its affairs so as to reduce tax liability...*but it must be within the power of the party to arrange its affairs. If the party seeks the assistance of the Court to reduce its tax liability the Court should be the last instrument to grant such assistance or judicial process to defeat a tax liability...*here the tax cannot be avoided unless the Court lends its assistance, namely, by sanctioning the scheme of amalgamation. In other words, the judicial process is used or polluted to defeat the tax by forming an appropriate device or subterfuge. Such a situation can never be said to be in the public interest and on this ground the Court would not sanction the scheme of amalgamation. (Emphasis Supplied)

The key question is “when can the corporate veil be lifted?” The answer from judicial rulings seems to be: when the device of incorporation is used for an illegal, improper or fraudulent purpose or when mandated by specific provisions of law or contract.

Empirical data on corporate veil piercing is available, as far as we know, only in the USA. A study by Thompson³⁰ showed 1,583 veil piercing cases before 1985 with 40% cases resulting in veil piercing. This should again be rich fodder for the aspiring legal researcher!

India’s stand in corporate veil piercing has been that the Courts typically will not pierce corporate veil in tax cases. However with some recent decisions it feels like the tide is changing; for example, refer *Ansaldo Energia SPA*³¹ case where ASPL India was “pierced” and 4 contracts were treated as a composite contract. The recent *Vodafone*³² case is discussed in more detail in a later section but there is some apprehension as to whether it will represent a new frontier in corporate veil piercing by Indian courts.

³⁰ Robert B.Thompson, *Piercing the Corporate Veil, an Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

³¹ *Ansaldo Energia SPA v. ITAT*, Tax Case No. 1303 of 2007, Jan. 12, 2009 (Mad.) (High Court of Madras).

³² *Vodafone International Holdings BV v. Union of India*, (2008) 175 Taxmann 399 (Bom.) (High Court of Bombay).

(iii) Civil doctrines

Courts in many countries have tended to apply civil law doctrines to control general tax abuse. The main civil law doctrines used are:

a) Abuse of Right (“Abus de Droit”)

Several jurisdictions apply the form and purpose rules of abuse of right doctrine under Civil Law (Example: Austria, France etc). The abuse of right is the manipulation of the intention or spirit of the law. Courts typically disregard the legal form where transactions are solely undertaken to avoid tax.

b) Abuse of Law (“Fraus Legis”)

Many civil law countries apply the Roman law doctrine of *fraus legis*. A good example is The Netherlands. *Fraus legis* resembles the business purpose rule. Under this, the Court disregards any transaction entered for tax avoidance purposes and substitutes it by a “normal” transaction.

c) Doctrine of Simulation

Certain civil law countries, like Belgium, apply this doctrine to ensure ‘substance over form’. It arises when there is no real transaction or there is a hidden real transaction or relationship. In such cases tax authorities can disregard the simulated transaction and replace it with the real one. This principle resembles the sham transaction or doctrine of wrong label. Examples of simulation include sale and leaseback transactions where the respective rights and obligations of the parties are not transferred in substance.

C. Legislative Anti-Avoidance Measures

(i) SAAR & GAAR

Two kinds of statutory anti-avoidance measures exist: GAAR and SAAR. The GAAR as its name implies is a set of general anti-avoidance rules; think of it as a “catch-all” for tax avoidance. The SAAR is a specific anti-avoidance rule and is targeted at curbing a specific avoidance practice or technique.

a. What is the rationale behind GAAR?

It is easy to understand the need for SAARs and their source of evolution – typically by judicial rulings or as a reaction to a commonly used avoidance

technique in the marketplace. However what is the rationale for having GAAR provisions? Justice Murphy said it best in *Federal Commissioner of Taxation v. Hancock*, “The resource of ingenious minds to avoid revenue laws has always proved inexhaustible and for that reason it is neither possible nor safe to say in advance what must be found....”³³

The advantages of GAAR are that given tax avoidance schemes are becoming increasingly complex and tough to anticipate via SAARs, governments across the world want to stop losing what they perceive as billions of dollars of revenue and so implement GAAR provisions as a ‘catch-all’ scheme for tax avoidance in general.

On the downside, the real problem with GAAR is that it can end up promoting *uncertainty*. It is a good time to recollect what Adam Smith said about taxes – that certainty is valued more than fairness and simplicity. The GAAR may also be construed as contrary to the rule of law principle, i.e., laws are meant to be reasonably certain or predictable.

In fact, the Canadian GAAR when introduced was challenged as unconstitutional on these grounds but the Canadian Supreme Court held that broad, purposive interpretation of GAAR is appropriate; refer *Canada Trustco Mortgage* case.³⁴

A GAAR is basically an attempt to strike down avoidance that is not understood at the time of drafting. The difficulty with having such a broad scheme has been heavily debated in various countries as and when they grappled with the thought of introducing GAAR. For example the Taxation Review Committee, 1975, Australia debated:

In framing legislation sufficiently all-embracing to deter tax avoidance, there is always the danger of penalizing those who have a genuine reason for entering into a bona fide transaction, which, if carried out by others, has the objective that ought to be prevented. There is frequently such a very fine line to be drawn between the transaction which offends and the one which merits no condemnation.

³³ Federal Commissioner of Taxation v. Hancock, (1961) 8 ATR 328, 333.

³⁴ Canada Trustco Mortgage Co v. Canada, 2005 2 S.C.R. 601 (Supreme Court of Canada).

It must be noted that developed countries like USA, UK do not have statutory GAAR. Rather, judicial doctrines combined with SAARs (prospective & retrospective) and other administrative measures seem to be the right mix for them.

A really interesting question (yet another prime material for the legal minds) is whether GAAR really does slow tax avoidance; in fact, can there be an opposite effect? Waincymer's research lead to his commentary on how when Barwick High Court (Australia) strictly interpreted GAAR, it lead to an increase in the level of tax avoidance in Australia! He states:

One intuitive lesson to learn from the Australian experience is that when tax avoidance became virtually sanctioned by the High Court in the 1970's, supermarket style off-the-shelf tax avoidance packages reached epidemic proportions. Having the Chief Justice of the High Court propound taxpayer rights would surely be a powerful rationalizing factor for taxpayers and advisers.

In a similar vein, noted Canadian tax expert Arnold considers the Canadian experience to demonstrate GAAR will only slow avoidance when interpreted purposively and when narrowly interpreted it may actually lead to more tax avoidance. He points out that when the Canadian Supreme Court in one of its rulings endorsed a purposive approach of the provisions, Revenue Canada responded by interpreting provisions literally. Further Revenue Canada announced it would issue advanced tax rulings and issued a Declaration of Taxpayer Rights which provided that taxpayers "have a right to arrange affairs in order to pay the minimum tax required by law." According to Arnold, response of taxpayers and their advisers to the approach of Revenue Canada was to engage in aggressive tax planning which ultimately lead to shortfalls in collections of taxes.

(b) SAAR

There are many examples of SAARs around the world enacted by various countries. Some examples are thin capitalization rules and CFC (controlled foreign corporation) rules which are passed to curb specific tax avoidance techniques; suffice to say these are elaborated upon in the later section on tax avoidance and counter measures.

Typically SAARs are prospective; however they can retrospective too and the increasing use of retrospective SAARs is a cause of concern for taxpayers.

(c) Treaty anti-avoidance provisions

Tax treaties (DTAAs) have evolved over time to include a plethora of anti-avoidance provisions in them. Some of the examples are:

- Arm's-length definition for related party transactions (Article 9) to defeat transfer pricing manipulation,
- Limitation on Benefit (LOB) clauses to counter treaty shopping,
- The concept of "beneficial ownership" applied to Interests, Dividends & Royalties (Article 10, 11 and 12) and
- Specific provisions against transactions with tax havens.

All the above measures are dealt with in later sections of this paper when tax avoidance techniques and counter measures are elaborately discussed. Hence, we do not wish to duplicate the same content here but wish to point out that tax treaties are evolving documents and are good weapons in the hands of both Governments (in case of bilateral treaties) to sit down and come up with ways and means to curb tax avoidance. It must be noted that the continuing contribution by academic and legal experts at OECD (and the UN), whose Model Conventions³⁵ most countries follow is critical in this regard.

One anti-avoidance measure which we need to mention and which is not discussed elsewhere in this paper is the Exchange of Information Articles in the treaties. Article 26 of the OECD Model Convention is a widely accepted legal basis for bilateral exchange of information for tax purposes. It creates an obligation to exchange information that is foreseeably relevant to correct application of a tax convention as well as for the purposes of administration and enforcement of domestic laws of the Contracting States. This Article serves as an important tool to detect and gather information on tax avoidance.

A related development is that of Taxation Information Exchange Agreements. The OECD has developed a process that enables certain non-OECD offshore financial centre jurisdictions to commit to eliminating harmful international tax avoidance and evasion practices. These jurisdictions can do this by committing to a program of exchange of information agreements with OECD member countries.

³⁵ OECD Model Tax Convention on Income and on Capital, January 2003; Canada Trustco Mortgage Co v. Canada, 2005 2 S.C.R. 601 (Supreme Court of Canada).

The OECD member countries and committed jurisdictions are collectively known as 'participating partners'. There are a number of non-OECD offshore financial centre jurisdictions committed to such taxation information exchange agreements (TIEA). These agreements aim to establish effective information exchange and improve transparency of taxpayers' financial arrangements/transactions for tax purposes and also provide important momentum to achieve the aims of the OECD's harmful tax practices initiative.

D. Administrative anti-avoidance measures

Administrative measures are mainly to ensure compliance and/or to detect tax avoidance. They are usually carried out in the following ways:

- a) By use of investigative powers when a GAAR exists
- b) By use of administrative powers to build a common law avoidance case, in jurisdictions where no GAAR exists (example: New South Wales, Australia)
- c) By use of taxpayer alerts & rulings – these typically discuss how an administration intends to apply statutory GAAR
- d) By appointing GAAR panels to decide GAAR issues.

Exchange controls & tax clearances are also used by countries as anti-avoidance measures; these transactions are subject to either prior government approvals or to post-transaction reporting of income or capital flows. For example, Canada requires its residents to report all foreign investments in excess of 100,000 Canadian dollars to tax authorities. Many countries, especially developing, still have partial or full exchange controls on current and/or capital account that monitor tax issues on cross-border transactions.

III. ANTI-AVOIDANCE – A WORLD WIDE SURVEY

It is illuminating to see the anti-avoidance measures used in various countries around the world.³⁶ It seems that a combination of the various techniques discussed in previous sections, have been used to combat tax avoidance. One feels it would make an interesting study as to possible reasons for each country to choose to evolve a particular set of anti-avoidance measures.

³⁶ *Supra* note 7, at 153.

Country	Short summary of anti-avoidance measures
Australia	<ul style="list-style-type: none"> • GAAR since 1981 Income Tax Act. • Courts have shifted over the years to purposive interpretation from a literal approach.
Austria	<ul style="list-style-type: none"> • Taxpayer is free to arrange affairs but broad limitations are placed under the GAAR. • However, tax avoidance must be main or only motive of taxpayer arrangements and strict burden of proof on tax authorities; it is considered irrelevant that arrangements are “unusual”.
Belgium	<ul style="list-style-type: none"> • Traditionally applied civil law of <i>simulation</i> (also known as Brepols doctrine). • Normally adopts strict, literal interpretation, i.e., legal form over substance is usually considered. • GAAR was adopted in 1993, advanced rulings can be obtained for GAAR.
Denmark	<ul style="list-style-type: none"> • Applies substance over form under a “correct recipient of income” principle.
Canada	<ul style="list-style-type: none"> • In <i>Stuart</i> (1984), the Supreme Court expressly rejected the business purpose test and reaffirmed the <i>Duke of Westminster</i> doctrine. • Enacted a GAAR in 1988; specific criteria for applying GAAR set out by the Courts and benefit of doubt given to taxpayer.
France	<ul style="list-style-type: none"> • Tax avoidance (<i>evasion fiscale</i>) lies between tax evasion (<i>fraude fiscale</i>) and tax planning (<i>habilete fiscale</i>). • Abuse of rights (<i>abus de droit</i>) doctrine based on decisions of Conseil d’Etat and Cour de Cassation. • Two tests of tax avoidance laid down: <ul style="list-style-type: none"> • Sole purpose to avoid tax (<i>fraude a la loi</i>) or • transaction is fictitious (<i>simulation</i>) • Also apply doctrine of “abnormal management act” (<i>acte normal de gestion</i>).

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	<ul style="list-style-type: none"> • Generally Courts favour the taxpayer; it is not unlawful to choose the most economical, legal and financial way from a tax viewpoint.
Germany	<ul style="list-style-type: none"> • Contains GAAR in tax code (AO). Legal structures can be disregarded under “abuse of form and legal structures” provision. • Courts apply substance over form; use the principle of analogy and teleological reduction in their decisions. Advance rulings are given. • Germany has one of the highest numbers of anti-avoidance related cases.
India	<ul style="list-style-type: none"> • No GAAR yet. Domestic law has SAAR provisions (e.g., sections 37(1) and 40A(2), Income Tax Act, 1961). • Underlying principles implemented through judicial and administrative decisions. • Courts have favoured taxpayer historically and taken literal view. (Ref: <i>Kulandagan Chettiar</i>, <i>R.M.Muthaiah</i> and <i>S.R.M Firm</i> cases). • <i>Azadi Bachao Andolan</i> was a landmark case which accepted that every man was entitled to arrange his own affairs as not to attract taxes (reaffirming <i>Duke of Westminster</i> principle and distinguishing <i>McDowell</i>).
Israel	<ul style="list-style-type: none"> • Specific measures to counteract tax planning involving foreign professional companies (FPC), • Has a GAAR (section 86, Income Tax Ordinance).
Italy	<ul style="list-style-type: none"> • Follows letter of law where form takes precedence over substance. • Tax avoidance so far handled through statutory provisions (SAARs). • Earlier efforts to introduce GAAR were unsuccessful.
Japan	<ul style="list-style-type: none"> • Has authority to re-compute tax base of corporate income tax, amount of net loss and corporate tax payable.

Netherlands	<ul style="list-style-type: none"> • Dutch Law provides for a GAAR though Courts rely on <i>fraus legis</i> (abuse of law).
Portugal	<ul style="list-style-type: none"> • GAAR introduced in 1999. • Burden of proof remains with tax authorities to show primary intention of tax avoidance.
Spain	<ul style="list-style-type: none"> • Tax code allows taxation of transactions based on their real economic nature, irrespective of legal form. • Civil Code has also codified the abuse of law principle – two special provisions namely <i>fraus legis</i> and <i>simulation</i>.
Sweden	<ul style="list-style-type: none"> • Attempted several versions of GAAR. The Tax Avoidance Act, 1995 was amended in 1998. • Burden of proof lies with tax authorities and advance rulings are given. • Furthermore, law specifies that the GAAR can only be applied under a Court order by tax authorities.
Switzerland	<ul style="list-style-type: none"> • Applies both business purpose and substance over form doctrine under its law. • In tax avoidance cases the tax authorities can substitute the customary construction for the transaction and tax accordingly.
United Kingdom	<ul style="list-style-type: none"> • Does not have statutory GAAR. • Do not accept principle of abuse of rights as applied in civil law jurisdictions (Ref: <i>Chapman v. Honig</i>). • In principle, tax avoidance is legal and tax evasion illegal; transaction must not be unlawful and purpose/motive must not be affected by specific anti-avoidance provisions. • U.K. Courts traditionally follow literal approach rather than purposive. • Early U.K. decisions favour taxpayer (Ref: <i>Duke of Westminster, Ayrshire Pullman Motor Service</i>, etc.).

	<ul style="list-style-type: none"> • U.K. Courts have also taken a purposive approach in several legal decisions: <i>Ramsay</i> case, <i>Furniss v. Dawson</i>, <i>McGuckian</i> case. • U.K. Courts still maintain that role of Courts to legislate and look-through only in blatantly artificial transactions (Ref: <i>Craven v. White</i> (1988)). • Government primarily relies on SAAR and judicial decisions. No GAAR was enacted though in 1988 the Revenue published a consultative document but it was decided subsequently not to implement any GAAR.
United States	<ul style="list-style-type: none"> • Does not have statutory GAAR. • The Courts have evolved several judicial anti-avoidance doctrines. • <i>Gregory v. Helvering</i> (1935) held that any one may arrange their affairs that his taxes shall be as low as possible. • Courts tend to apply substance over form (Ref: <i>Aiken Industries and Johansson v. USA</i>). • Similarly, transactions or series of transactions without a business purpose may be ignored.

IV. TAX AVOIDANCE TECHNIQUES & COUNTER MEASURES

A. Tax Avoidance Technique #1 – Treaty Shopping

The “abuse of tax treaties” is the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits that the treaty were not designed to give. Treaty shopping connotes a premeditated effort to take advantage of the international tax treaty network and a careful selection of the most favourable tax treaty for a specific purpose (refer to *Rosenbloom H.D, Tax Treaty Abuse: Problems & Issues*).

(i) Treaty Shopping structures

There are a variety of treaty shopping structures. Some of them are:

a) Direct Conduits

A direct conduit works as shown in the diagram below. Resident of State R expects to derive dividends, interest or royalties sourced in another state (State S). So it sets up entity in a third state (State C) that will receive dividends, interest and royalties in a more tax beneficial way than if income were paid directly from State S to R. The tax advantage results from fact that tax treaty between S and C provides for more advantageous withholding tax rate in State S if paid to State C resident than if paid to State R resident.

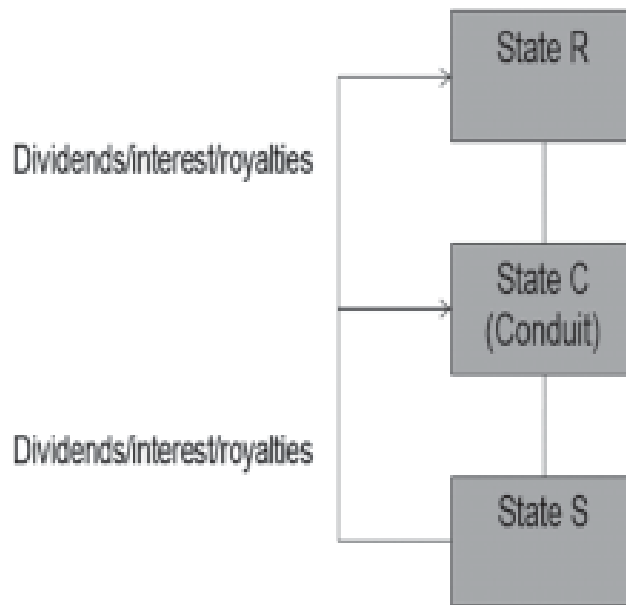


Figure 3: Direct conduit structure

b) Stepping stone conduit

A stepping stone conduit works as follows: Residents of State R establish company resident in State C where it is fully subject to tax on income derived from S. However it pays high interest, royalties, service fees, commissions &

other expenses to a second related foreign company (base company) set up in a fourth state (State B) and controlled by shareholders of the conduit company. These payments are deductible in State C and are either not taxed or very advantageously taxed in State B because the company enjoys a preferential tax regime there.

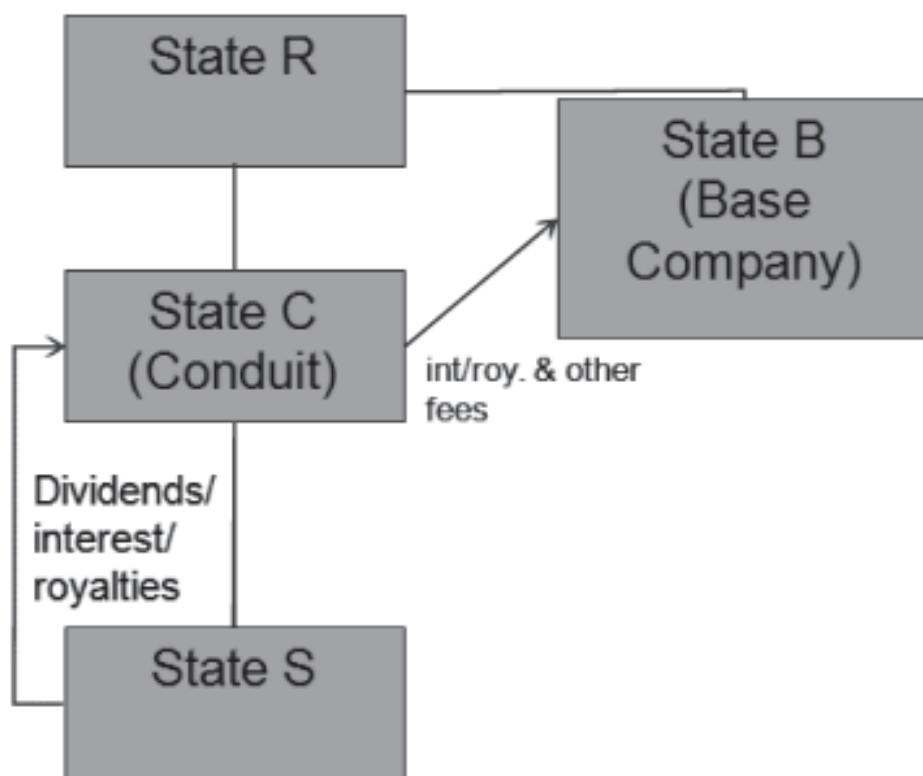


Figure 4: *Stepping Stone conduit structure*

c) *Other structures*

There are other treaty shopping techniques in practice; examples are triangular structures where a low or nil taxed branch of a company in a treaty country receives income from a third country. Another approach is to use **hybrid entities** that are characterized differently in the two Contracting States. Individuals can also treaty shop by transferring tax residence to another treaty country, i.e., 'emigration' - also a form of treaty shopping. For instance, a resident of France owning an important shareholding in French company may emigrate

to Belgium in view of later sale of shares because under Article 18 of Belgium-France tax treaty the right to tax the capital gain is conferred to Belgium but Belgium does not levy capital gains tax on individuals (except speculation).

In fact, the national policies of many countries favour treaty shopping. Source countries may encourage (or at least, not discourage) it. Residence countries may permit to develop overseas markets or improve competitiveness and/or limit source taxation. For example, treaty shopping is encouraged in EU if it helps to break national boundaries and create a single market. Also, generally developing countries may view treaty shopping as a tax incentive.

In other words treaty shopping, when it is beneficial may be tacitly approved and when disadvantageous may be disapproved. For example, some of them have revoked tax treaties in cases of circular situations when the income is sourced in the same country where the shareholder is resident but the income passes through a company resident in another country for tax reasons, i.e., “round tripping”. This has been considered abusive by India, Brazil, Indonesia, etc.

(ii) Approaches against Treaty Shopping³⁷

- a) Neutral measures by combining domestic and tax treaty provisions. Example: non-domiciled residents in U.K. may be entitled to treaty benefits on foreign income only when remitted.
- b) Specific measures that deny benefits to entities which are not subject to tax in their state of residence.
- c) Purpose-based measures that deny certain treaty benefits set up only for claiming such benefits. Example is no tax refunds are given under Netherlands treaty with the U.K. in such cases.
- d) Comprehensive measures imposed under domestic legislation or treaties. For example, Article 22, U.S. Model Treaty on Limitation on Benefits, 1996; Swiss Abuse Doctrine, 1962.

(iii) Treaty Shopping and the OECD Model’s “Beneficial Ownership”

The OECD Model Convention³⁸ has long recognized the problems caused by treaty shopping. The OECD Model Convention has the concept of “beneficial

³⁷ *Supra* note 7, at 167-182.

³⁸ OECD Model Tax Convention on Income and on Capital, January 2003.

owner” applied to Article 10 (dividends), Article 11 (interest) and Article 12 (royalties). Beneficial ownership is not just legal but also economic. There have been various OECD reports over time which have constantly refined the approach to combat Treaty Shopping –

- OECD Report on Use of Conduit Companies (1987)
- Harmful Tax Competition (1988)
- Commentary Update 2003

(iv) Treaty Shopping & Limitation on Benefit (LOB) clauses

Generally these LOB clauses exclude resident companies from tax treaty benefits unless they have a sufficiently strong nexus to the contracting state where they claim residence.

Such provisions may limit benefits to companies which have a:

- Certain minimum level of local ownership (*look-through approach*)
- Deny benefits to companies which benefit from a privileged tax regime (*exclusion approach*)
- Deny benefits to companies which are not subject to tax in respect of income in question (*subject-to-tax approach*)
- Deny benefits to companies which pay on more than a certain proportion of the income in tax deductible form (*channel approach*)

(v) Treaty Shopping & India

In the *Azadi Bachao Andolan* case,³⁹ the Supreme Court held that there was no inherent anti-abuse rule in Indian tax treaties and hence it required specific LOB clause in the treaty itself for the denial of treaty rights. Treaty shopping is not illegal:

Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses

³⁹ Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 706 (Supreme Court of India).

are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses. Whether it should continue, and if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations.

B. Tax Avoidance Technique #2 – Controlled Foreign Corporation⁴⁰

Foreign-sourced income is taxed after it is accrued as income in the country of residence of the recipient; thus it becomes possible to defer (or avoid) tax on foreign dividend income until it is repatriated (for example, by not declaring dividends or receiving them in an entity located in a “tax haven”). Several countries prevent their residents from accumulating funds abroad through exchange control restrictions. As countries increasingly ease their exchange control rules many of them have enacted Controlled Foreign Corporation [hereinafter “CFC”] rules to ensure there is no deferral of taxes on the foreign income.

Under the CFC rules, the domestic law effectively extends the residence tax rules to the income. It requires that the tax due on foreign profits, whether distributed or not, be paid currently at home by tax residents.

CFC rules are normally applied in cases where the resident shareholders, individually or collectively, have substantial influence or control over a foreign corporation. Note that the said control could be equity or voting or ability to share profit or assets on liquidation or nominative (de facto) control. The level of control requirement (i.e., the “control test”) by resident shareholders to qualify as a CFC varies widely.

For example:⁴¹

- a) More than 50% equity or voting rights (i.e., control)
 - All resident shareholders: Germany, Israel, Japan, Portugal, South Africa, U.K.
 - Five or fewer resident shareholders: Canada, United States
 - Single resident shareholder: Brazil, Denmark, Italy, Lithuania

⁴⁰ *Supra* note 7, at 184-189.

⁴¹ *Supra* note 7, at 184-189.

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- b) At least 50% (i.e., substantial influence)
 - All resident shareholders – Finland, Norway, Sweden, Turkey
 - Five or fewer resident shareholders – Australia, New Zealand
 - Single resident shareholder – France, Israel, Korea, Spain
- c) Less than 50% but one resident shareholder has significant influence
 - Single resident shareholder – 40% or more share ownership in Australia and New Zealand; 25% or more equity in Denmark, Portugal and Sweden; and at least 5% equity with minimum investment of 50% equity control through a corporate group in France.
- d) Countries which do not have any *CFC* legislation
 - India, Austria, Belgium, Iceland, Ireland, Greece, Luxembourg, Netherlands, Poland, Switzerland.

An important question must be answered: what transactions are taxable under these *CFC* rules? Not all transactions are subject to *CFC* rules, they only apply to the attributable income of the controlled foreign corporation. Countries take different approaches for arriving at the attributable income:

i) Locational/designated jurisdictional approach

- Countries may be defined under a “white list” or “black list”.
- Several countries compare the effective foreign tax rate with their own effective rate, as computed on similar income under tax principles. *CFC* rules then apply to countries that have an effective rate equal or below minimum specified rate.

ii) Transactional approach

- Targets “tainted” income; usually passive income and specific active income.
- Such tainted income is attributed to domestic shareholders, subject to exemptions (Examples: United States, Canada).

C. Tax Avoidance Technique #3 – Thin Capitalization

Debt financing of cross-border transactions is often (not always) favourable than equity financing for taxpayer.⁴² In certain cases, dividend receipts may be

⁴² *Supra* note 7, at 214-237.

preferable to interest income; for example if the dividends are tax exempted and interest received is subject to a relatively high tax rate in the state of residence. Thin Capitalization refers to excessive use of debt over equity capital; this can be via hidden equity capitalization through excessive loans (or) the artificial use of interest-bearing debt instead of equity by shareholders with the sole or primary motive to benefit from tax advantages.

Some countries have thin capitalization rules which are primarily concerned with loan capital provided by non-resident lenders, who are also substantial shareholders of a domestic company. As expected, these rules vary widely in countries that do apply the thin capitalization rules.

At the basis of thin capitalization is the use of debt instead of equity; normally such use of debt instead of equity has several tax and non-tax advantages. For example:

- Interest expense is tax-deductible whereas dividend payments are not
- Unlike interest, dividends are usually subject to economic double taxation
- Debt financing avoids wealth taxes, net worth taxes and other capital duties imposed on equity contributions
- Debt allows the repatriation of capital invested as loan repayment without tax consequences
- It is possible to select currency of debt to minimize foreign exchange risks; equity is normally denominated in the currency of the host country
- Debt provides greater flexibility since it is possible to convert debt to equity but not the reverse
- Withholding tax on interest is often nil or lower than on dividends.

Approaches to thin capitalization taken by countries worldwide can be categorized as follows:⁴³

- i) **Arms-Length approach:** Based on general principle of thin capitalisation; would an unrelated party provide debt funds on same basis as related party loan arrangement?

⁴³ *Supra* note 7, at 214-237.

- ii) **Hidden Profit distribution:** Specific provisions under tax law allow loan interest to be reclassified as “constructive dividend”; these apply usually when lender and borrower are related persons or have defined relationship. It may also apply if subsidiary company is undercapitalized and a loan from parent is of a permanent nature or on non arm’s-length basis.
- iii) **“No rules” approach:** No specific rules; use GAAR and judicial doctrines
- iv) **Fixed Ratio approach:** Specify maximum debt-equity ratio in the rules

It must be noted that rules under domestic law on international thin capitalization may be limited or overridden by double tax treaties. Also, many countries, as yet, do not have any thin capitalization rules; examples are India, Finland, Iceland, Ireland, Sweden, Israel, Indonesia, Brazil, Singapore, etc.

D. Tax Avoidance Technique #4 – Transfer Pricing Manipulation

Transfer pricing is an economic term which refers to valuation process for transactions between related entities. The real issue is the sharing of taxable income by countries in which the MNEs operate lawfully.

Transfer pricing affects situations when goods and services are provided, knowingly or otherwise, on a non arm’s-length basis by related entities.

Let us consider an example where transfer pricing manipulation can occur: suppose a corporation manufactures products in country A and sells the finished products in country B (via its subsidiary S) to unrelated parties (say, the public at large). In such a case S’s taxable profit is determined by three factors:

- a) price at which it resells products to the unrelated parties
- b) price at which the products were obtained from its parent corporation
- c) its expenses other than cost of goods sold.

Now if country A, where the products are manufactured, has a tax rate much lower than B’s tax rate where the products are sold to unrelated parties, then the corporation would try to book as much profit as possible in country A and towards this show a very low sale value of products to country B. If the tax rate were higher in A than in B then the corporation would show a very high sale value and concentrate almost the entire profit in the hands of the manufacturer (country A). This is a clear example of when associated enterprises deal with each other, their financial relations may not be directly affected by market forces but other considerations.

Towards such transfer pricing issues, the arm's length principle (Article 9, OECD MC) has been evolved; it seeks to determine whether the transactions between related taxpayers (in this case the corporation and its subsidiary S) reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

Arriving at the appropriate arm's length price is done through a plethora of transfer pricing methods, which usually prove to be a point of contention between the taxpayers and the revenue.

It must be noted that there are many transactions which may involve such transfer pricing issues:⁴⁴

- **Transfer pricing of tangible property.** For example, sale and purchase of inventory and other physical assets.
- **Transfer of machinery, rental of property & leasing arrangements.** For example, re-invoicing or "turnaround" companies.
- **Transfer pricing of intangible property rights.** For example, manufacturing /trade & marketing intangibles.
- **Provision of services.** For example, provision of technical services with or without transfer of an intangible right. Management assistance and services, sharing of overhead costs.
- **Provision of finance.** For example, interest rate, amount, guarantee or collaterals on related party debt; short-term working capital finance through inter-company transactions; market penetration or maintenance payments through reduction in TP; credit terms and financing arrangements including deferred payment arrangements or factoring of inter-company debts.

Countries typically tend to limit their transfer pricing rules to cross-border related transactions only; however several of them include similar domestic transactions as well. Some examples are Canada, Belgium, Denmark, Greece, Poland, Portugal, Slovenia, United Kingdom, and United States.

Furthermore, as noted above, countries typically apply transfer pricing rules to certain related party transactions. However, some countries use a broader definition of "associated enterprises" based on mutual benefit or influence like

⁴⁴ *Supra* note 7, at 239-274.

India, China and Korea. Few countries include transactions with preferential tax regimes and tax havens under transfer pricing rules like Argentina, Brazil, Latvia and Turkey. Many countries still do not have specific transfer pricing rules in their domestic tax law and rely on other anti-avoidance rules, if they exist.

There are countries which have **safe-harbour** rules under which they grant partial or total relief from transfer pricing obligations. For example, in Brazil the agreed minimum percentage mark-ups based on industry norms may be used in specific transactions.

Many countries have established procedures to grant transfer pricing rulings under an “advance pricing arrangement” (APA). These APAs provide for certainty for the taxpayer on the taxation of certain cross-border transactions. These arrangements may be bilateral or multilateral. A major issue with transfer pricing rules is that of contemporaneous documentation. Countries which adopt the OECD Guidelines usually enforce the rules through the requirements that the taxpayer maintain and provide such documentation to support the compliance with them under their domestic tax law. Non-compliance with documentation rules which are usually subject to external review (say, by accountants) may face heavy penalties. This documentation is a major issue because of the enormous overhead cost it creates for the multinational taxpayer.

*E. Tax avoidance Technique #5 – Transfer of Residence*⁴⁵

Certain countries regard a transfer of residence as a form of tax avoidance. In jurisdictions with worldwide tax regime, taxpayers when they become non-residents are no longer liable to pay taxes on their foreign source income. Moreover, the gains on movable property accrued during period of residence but realized at time of departure also escape taxation. Such countries have enacted SAARs to prevent tax avoidance through emigration. Examples are Australia, Canada, Denmark, U.S.A., etc.

Regarding Transfer of Corporate Residence, the transfer may require company to be wound up or deemed as liquidated in several civil law jurisdictions (Example: Australia, Belgium, Denmark, Sweden). If a German company transfers its head office abroad, the law will dissolve it; a foreign company cannot transfer its registered office to Germany. Certain countries choose to impose an “exit tax”⁴⁶ when company ceases to be their resident - the company in such a case is subject to a capital gain on its deemed sale. Examples include United States, UK, Canada and Austria.

F. Tax avoidance Technique #6 – Branch Entities

Under a classical tax system, host country taxes the corporate profits twice – at company level and again when company pays dividend. Most countries do not tax remittances of after-tax branch profits to non-residents. A branch entity therefore avoids this economic double taxation.⁴⁷

Several jurisdictions regard the use of a branch as an unjustified loss of tax revenue that would have been due to them as dividend withholding taxes from a subsidiary. Thus, an additional tax either on branch profits or on remittances to head office is levied.

G. Tax avoidance Technique #7 – Tax Havens

Tax havens are jurisdictions which tend to have nil or low taxation. Tax havens may also be jurisdictions which have other benefits like financial secrecy, minimum reporting requirements, ring fencing, discretionary tax privileges, allowing ownership to be held in trust, no registry of companies and partnerships, no taxes on dividends and interest payments to non-residents, etc.

Some examples⁴⁸ of Tax havens are:

- Zero-tax jurisdictions: Panama, Cayman Islands, Bahamas, etc.
- Low-tax jurisdictions: Guernsey, Jersey, Bermuda, Isle of Man, etc.
- Captive insurance: Bermuda, Barbados, Madeira, Labuan, Ireland, etc.
- Offshore banking: Cayman Islands, Switzerland, Luxembourg, Jersey, etc.
- Collective investment schemes: Hong Kong, Cayman Islands, Switzerland, Luxembourg, Bermuda, Guernsey, Jersey, Dublin (Ireland), etc.
- International Shipping: Liberia, Panama, Malta, Isle of Man, Gibraltar, etc.

Several countries have SAARs, i.e., specific anti-avoidance legislation to limit the deductions of tax expense or grant of tax benefits to entities located in certain *blacklisted* countries.

⁴⁵ *Supra* note 7, at 278-290.

⁴⁶ *Supra* note 7, at 278-290.

⁴⁷ *Supra* note 7, at 278-290.

⁴⁸ *Supra* note 7, at 291.

V. INTERESTING LEGAL QUESTIONS RELATED TO ANTI-AVOIDANCE

There are several interesting legal questions related to the interplay of domestic laws and treaties (DTAAs).

Q1) Where do the treaties stand with respect to domestic tax avoidance measures passed by countries?

Do the relevant domestic rules

- complement tax treaties?
- do they limit the application of treaties?
- are they limited by tax treaties?
- are they designed to circumvent limitations in treaties?

After the changes in 2003, Article 1 of the OECD Commentary concludes that domestic law anti-abuse rules do not conflict with treaties though Portugal has expressed strong reservation to this conclusion.

As usual, countries follow differing policies with respect to resolving the conflict between treaties and domestic anti-avoidance provisions. The Indian view currently is that tax treaties override domestic anti-avoidance rules. USA and Germany try to reconcile domestic provisions with treaties but treaty override does occur; the USA follows a “later in-time rule” for conflict resolution.

It is our view that most domestic rules & treaties can indeed be reconciled on most issues like base companies, transfer of residence, base erosion and character of income. However one cannot give a blanket statement because some domestic rules may exist on thorny issues which cannot to be reconciled easily with treaties. Good examples are:

- Re-characterization of debt that exceeds the debt-equity ratio into equity
- Limitation of application of thin capitalization rules to debt from non-resident taxpayers

Many experts feel that in the future, with the strong push for anti-avoidance, we might see a lot more cases being decided where the Courts hold the double tax treaty irrelevant.

Let's take the *Aznavour* case⁴⁹ for example. In this case, Charles Aznavour, the French singer was a resident in Switzerland and performed in France through a company established in U.K. Under French domestic law the income charged by the company was attributable to Aznavour and taxable to him. The Conseil d'Etat determined that the income tax treaty with U.K. was not applicable, because under French law the UK company was not regarded as a taxpayer with respect to the income and because the income was attributable to a resident of Switzerland, the treaty between France and Switzerland was applied and that Treaty did allow France to tax the income.

Q2) Is the abuse of tax treaty addressed by domestic law principles or by the interpretation of the tax treaty?

Countries as usual, respond differently to this question:

- Belgium believes abuse of treaty cannot be addressed without a domestic GAAR
- India, Finland, New Zealand etc. believe that abuse must be treated by interpretation of the treaty and they stress on following the Vienna Convention on the Law of Treaties (Article 31).

Some interesting case laws deserve mention in this regard:

a) MIL Investments case – Canada⁵⁰

The company, MIL Investments, was resident in Cayman Islands and it owned more than 10% of Diamond Field Resources Ltd. (DFR), a company resident in Canada. MIL entered into several transactions; in a tax-free transaction it exchanged a number of DFR shares with result that its interest decreased to less than 10% of DFR. Subsequently, MIL incorporated in Luxembourg & became resident there. MIL then sold some of the shares it had received in exchange for DFR shares and later it disposed of its entire interest in DFR, realizing a significant capital gain. The key point was that the capital gains were taxable under Canadian domestic law but if MIL could successfully invoke the protection of Article 13 of the Canada-Luxembourg DTAA, the gain would be exempt from taxation in Canada. Revenue Canada tried to argue that the Treaty is inapplicable. However,

⁴⁹ French Supreme Administrative Court, Mar 28, 2008, No 271366, 9th & 10th Section, Aznavour.

⁵⁰ MIL (Investments) S.A. v. The Queen, [2006] 5 C.T.C. 2552 (Can.) (Tax Court of Canada) (affirmed on other grounds, 2007 FCA 236).

though the Canadian Court was receptive to GAAR, it ruled in favour of MIL. Interestingly, Court tested the transaction against Canadian domestic GAAR, i.e., treaty abuse was addressed by application of domestic rules.

b) *Yanko-Weiss – Israel*⁵¹

Yanko-Weiss (Y-W), a company resident in Israel owned shares in a subsidiary that was also resident in Israel. In 1999, Y-W moved its effective management to Belgium and became a resident under Belgium tax law. In the following it received a dividend from the Israeli subsidiary and claimed reduced dividend withholding pursuant to the Belgium-Israel tax treaty. Israeli Revenue refused saying that the no economic purpose of residence in Belgium and emigration to Belgium should be treated as a sham. The Israeli Court confirmed that the Treaty benefits can indeed be denied in the presence of a sham transaction. The Israeli tax authorities took a view that domestic anti-avoidance rules are in line with the income tax treaty and hence treaty abuse can be addressed by application of domestic GAAR itself.

c) *“A Holding” case – Switzerland*⁵²

In this case, “A Holding ApS” a company resident in Guernsey had interposed a Danish holding company - “A Holding”, in order to own shares in a company resident in Switzerland. “A Holding” was a mere holding company without any economic activity and had been organized with a view to obtain benefits of the Denmark-Switzerland Treaty only. “A Holding” received a dividend from its Swiss subsidiary and invoked the benefits of Article 10 of the Denmark-Switzerland tax treaty. Swiss authorities denied benefit of the Treaty arguing that “A Holding” had only been organized with a view to obtaining Treaty benefits and granting such benefits would be abuse of the tax treaty. Court referred to the principle of abuse of rights in Denmark and denied “A Holding” benefits of the Treaty. Here again, treaty abuse was dealt with by domestic law principles.

d) *Azadi Bachao Andolan – India*⁵³

In this case, the lower tax authorities denied DTAA benefits to certain Mauritius resident companies investing in India. CBDT had clarified in

⁵¹ District Court decision 005663/07 Yanko-Weiss Holdings v. Holon Tax Assessment Officer dated Dec. 30, 2007.

⁵² “A Holding” ApS v. Federal Tax Administration, (2005) 8 I.T.L.R. 536 (Swiss Federal Court).

⁵³ Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 706 (Supreme Court of India).

Circular 789 that Mauritius certificate of residence is sufficient for claiming treaty benefits. The Supreme Court upheld the validity of Circular and the India-Mauritius Tax Treaty. It said that 'treaty shopping' per se is not illegal; specific safeguards may be in the treaty itself. The Supreme Court rejected the submission that an act which is otherwise valid in law can be treated as non est merely on the basis of some underlying motive supposedly resulting some economic detriment to the national interests, as perceived by Revenue. It also says that rule in *McDowell* cannot be read as laying down every attempt at tax planning is illegitimate.

Roy Saunders⁵⁴ asks even more fundamental & probing questions

- "Can we rely on double tax treaty provisions anymore?"
- "Are the taxes of just one country being avoided or in fact is double taxation being avoided?"

This discussion throws up many points to ponder. Treaties are "living" documents. Their interpretation has evolved over time. Substance has gradually become more important than form, especially as more complex tax avoidance schemes are evolved and newer financial instruments and technological innovations come about. It is clear that when push comes to shove, individual governments would want to collect tax from large cross-border transactions. In such a scenario, interplay & friction between treaty and domestic anti-avoidance provisions is inevitable.

VI. INDIA'S DTC: PROPOSED GAAR

The Indian government is set to introduce the Direct Tax Code [hereinafter "DTC"] in the coming year(s). The DTC⁵⁵ brings a number of changes to the existing Income Tax Act, 1961; we are chiefly concerned with the provisions of GAAR found in the DTC. According to the DTC:

The Commissioner is empowered to declare an arrangement as an impermissible avoidance arrangement (IAA) if:

⁵⁴ Roy Saunders, *New Developments: Recent Changes Affecting International Tax Planning*, ITPA Zurich, June 2009.

⁵⁵ Ministry of Finance, *Direct Taxes Code*, available at <http://finmin.nic.in/dtcode/index.html>.

Anti-Avoidance Measures

- The whole, a step or a part of the arrangement has been entered with the objective of obtaining tax benefit, and the arrangement:
 - Creates rights and obligations not normally created in arm's length transactions, or
 - Results in direct or indirect misuse or abuse of the provisions of the code, or
 - Lacks commercial substance in whole or part, or
 - Is not bona fide.

Once treated as an IAA, look through is permitted by:

- Disregarding whole or part of the impermissible avoidance arrangement
- Treating related or accommodating or connected parties as one and the same person
- Reallocating amongst parties or re-characterizing any accrual, receipt, expense, deduction, rebate etc. whether revenue or capital
- Re-characterizing debt or equity or vice versa.

Furthermore, a transaction "lacking commercial substance" is defined to include situations where there is:

- Significant tax benefits without a significant effect upon business risk or net cash flows
- Legal substance or effect differs from legal form
- It involves or includes:
 - Round trip financing
 - An accommodating or tax indifferent party
 - Any element that has the effect of offsetting or cancelling each other
 - A transaction which is conducted through one or more persons and disguises the nature, location, source, ownership or control of funds.

The GAAR can be invoked as an alternative to or in addition to any other basis of making an assessment. There is a presumption of purpose – the onus of proving that the purpose of transaction is not to avoid taxes is on the assessee.

Presumption applies even if main/overall purpose of arrangement is not to obtain a tax benefit and only if a step/part of the arrangement is to obtain a benefit.

Clearly, these rules offer a significantly wide scope to the Revenue; here are some points to ponder if this GAAR comes into law:

- a) Are these appealable orders? Will there be dispute resolution?
- b) Will Advance ruling (AAR) be given on such transactions?
- c) What are the penalties involved?
- d) Does this mean transfer pricing rule for all transactions (even domestic)?
- e) Thin-capitalization rules – what is the impact of currency law?
- f) No safe-harbours and/or guidance on threshold debt-equity ratios are provided

An interesting comment was made recently that the Indian GAAR seems to have been completely 'derived' from the recent South African GAAR. It is so closely 'derived' that in the South African GAAR, the Commissioner is empowered to pursue GAAR issues and the Indian GAAR seems to have the same wording though the Commissioner in South Africa is equivalent to the highest office of the CBDT here and is at a wholly different and higher position than the Indian Commissioner! If anything, the South African GAAR process of public debate & comments followed up by feedback with detailed analysis and findings before passage into law should be followed.

VII. INDIAN ANTI-AVOIDANCE & THE VODAFONE CASE

A. *Why study the Vodafone case?*

The highly publicized *Vodafone*⁵⁶ case is pending before the Courts as this article is being written. Hence we will merely delve into the facts of the case as known to us. The reason this case is of importance to an anti-avoidance discussion is that experts feel the outcome of this case may throw light on how the proposed GAAR will be pursued/interpreted in the coming years. Will substance over form prevail? Will piercing the corporate veil going to be common moving

⁵⁶ Vodafone International Holdings BV v. Union of India, (2008) 175 Taxmann 399 (Bom.) (High Court of Bombay).

forward? Do *Azadi Bachao* and *Vodafone* signal a generational shift? These are some of the questions this case raises at a broad level. In this paper we will simply examine the facts of the case and let the reader come to his/her own conclusions.

B. Background of Vodafone case

Vodafone acquired 66% interest of Hutchison (Hong Kong) in Hutch-Essar's (an Indian company) shares for USD 11 billion held by its Cayman holding company through its Dutch subsidiary. The Indian Revenue sent a "show cause" notice to Vodafone-Essar in India why the capital gains tax of around USD 1.7 billion should not be payable by them as underlying business and assets are based in India. Section 201 in the I.T. Act, 1961 has been amended in May 2008 retrospectively to make the foreign buyer liable to withhold Indian tax in such cases.

C. Overview of the Vodafone case & issues raised by the Revenue:

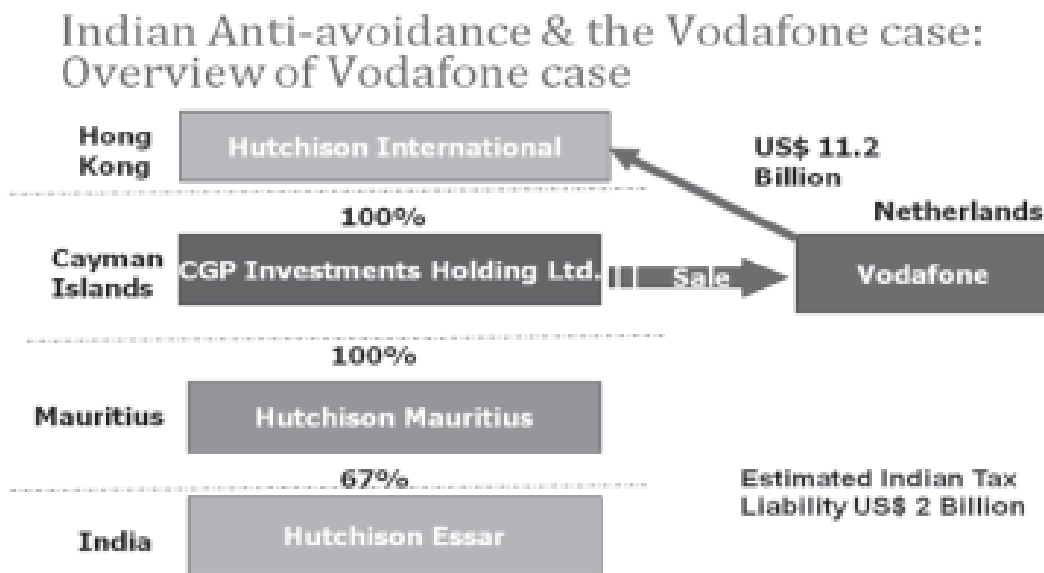


Figure 5: Overview of the *Vodafone* case

Issues raised by the department were:

- Indirect transfer of shares of Hutch-Essar (India) by Hutch International (Hong Kong).
- Allegation by Tax Department that Hutch International is liable to tax in India
- Vodafone-Essar (new Indian entity) is an agent of Hutch International, and hence liable to tax in India as 'representative assessee'.

- Tax authorities are assessing 400 plus similar cases. (Retrospective amendment backdated to 2002 made to tax withholding section by Budget 2008).
- Vodafone has challenged the notice and the amendment in Bombay High Court.

D. Legal process overview & current status

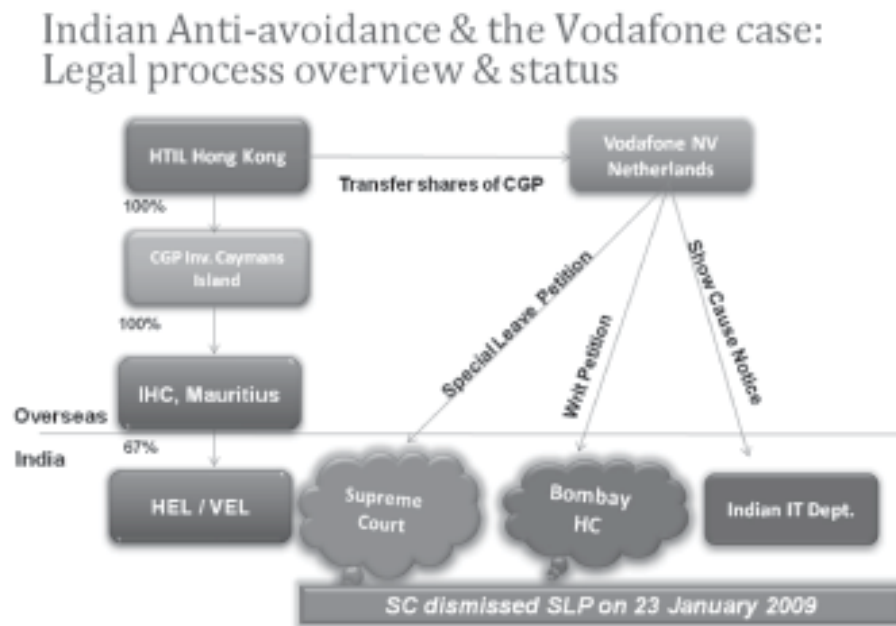


Figure 6: Legal process overview of *Vodafone* case

E. Facts of the *Vodafone* case

- Hutchison Telecommunications International invited bids from several investors for auctioning its investments in a Cayman Island Company.
- Indian Income Tax authorities sought requisite information from Vodafone with regard to the purchase of shares, by its group company based at Netherlands, of this Cayman Island Company owned by Hutchison, Hong Kong.
- The Cayman Island Company owned shares of a Mauritian Company which had invested into the shares of an Indian telecom company.
- Vodafone challenged this action of Indian tax authorities and sought to obtain injunction over the said action by filing a writ petition with Bombay High court.

F. Legal issues being debated

Income Tax Department & Vodafone sparring on the following legal issues

- Scope of Indian Income Tax Act over non-resident
- Section 201 (assessee in default) retrospective amendment
- “Transfer of a capital asset”
- Show-cause notice issues
- Territorial jurisdiction of Indian tax laws & authorities

G. Bombay High Court ruling

In the Bombay High Court, the tax authorities made a strong prima facie case that:

- The transaction was one of transfer of capital asset situated in India,
- It would be too simplistic to hold that Vodafone merely acquired the shares of an unknown Cayman Island Company, and
- The purpose of acquiring shares in the Cayman Island Company was to acquire controlling interest in the Indian Company and hence there seems to be transfer of capital asset situated in India.

Furthermore, the ‘effects doctrine’ has been approved and relied upon by the Supreme Court of India. Vodafone has not been able to demonstrate that the SCN is non est in the eyes of law for absolute want of the jurisdiction of the authorities. Also, Vodafone has failed to produce the relevant agreement/document without which it is impossible to appreciate the true nature of the transaction. It must also be noted that Vodafone’s interests are fully safeguarded by section 195 or 197 of the Income Tax Act. The Bombay High Court in light of all these facts dismissed the writ petition with costs to the tax authorities.

H. Supreme Court – Special Leave Petition

The Supreme Court dismissed the Special Leave Petition filed. The Supreme Court asked Vodafone to go back to the income tax department and file all relevant documents so that they can decide whether they have jurisdiction or not to serve notice on Vodafone.

The decision is thus open and **pending**.

I. Conclusion

Is this the precursor to Indian Revenue's anti-avoidance approach? From *Azadi Bachao* to *Vodafone* – is this an anti-avoidance zeitgeist? It is felt that when push comes to shove, Indian revenue authorities are not going to let treaty or any strict doctrines come in the way of tax collection. We are of the view that substance should be considered over form *if* it is concluded that there is indeed tax avoidance after genuine investigation of the transactions.

VIII. CONCLUSION

We have seen from our detailed tour of the world of tax avoidance and its counter measures that tax avoidance is a complex and evolving *game* and to counter this we can see that there are a plethora of techniques practiced by governments around the world ranging from judicial doctrines, SAAR and GAAR and administrative measures.

It seems to one that various countries are trying to constantly play *catch-up* with the evolving tax avoidance techniques in a never-ending cat & mouse game.

Coming to the proposed Indian GAAR in the DTC, it is an expected, but nevertheless significant step. The opening up of our economy, our high growth rate, the tremendous growth of foreign interest in Indian shores, the huge cross-border transactions and flows and the growth of our “intangible” economy has opened up a gift box for the investor but a Pandora's box as far as the Revenue is concerned, with aggressive tax planning and structuring being the order of the day. The Indian Revenue no doubt feels there is a huge loss to the Revenue due to the practice of various tax avoidance techniques and a GAAR is needed to cast a wide net in order to prevent to bring tax avoiders under their scanner.

The key issue is not so much that India is evolving a GAAR but more so the unfortunately frightening certainty of there being uncertainty and unpredictability for the taxpayers in the GAAR implementation by the Indian Revenue authorities. After all, the devil is in the details when it comes to GAAR due to its sweeping reach.

The unanswered questions on the back of everyone's mind are no doubt:

- a) Whether GAAR will be (mis)used as a catch-all mechanism by the Indian Revenue authorities. The past and current behaviour of the Revenue authorities will probably lead to sleepless nights for the taxpayer once the GAAR provisions are in place!

- b) How will the Indian Courts interpret the GAAR provisions? Historically they have been favourable to tax payer when it comes to things like treaty shopping (*Azadi Bachao Andolan*). But will there be a seismic shift?

An even more fundamental question is whether India really needs a GAAR and why the current system of a combination of judicial rulings and SAARs will not suffice? We hope that the Indian DTC GAAR is not a case of “calm before the storm”.

IX. ACKNOWLEDGEMENTS

An excellent source of reference is Roy Rohatgi’s **Basic International Taxation (Volume I & II)**,⁵⁷ important material for this paper was obtained from this source. Various other sources, including the Internet, played an important role in compiling this paper. References to all the sources are provided wherever possible; any omission or mistakes in them are to be kindly treated as genuine errors and not construed otherwise.

Furthermore, taxation, especially international taxation, is evolving at a very fast rate. By no means should this paper be used as a source of taxation advice and/or as a substitute for professional advice and research.

We wish to thank the National Law School, Bangalore and its excellent students & faculty, especially Mihir Naniwadekar, for giving us an opportunity to present and publish this paper.

⁵⁷ *Supra* note 7.