LIMITATION OF BENEFITS CLAUSE EXPLAINED

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Introduction

Taxation of cross – border transactions has always been a controversial aspect. In order to attract more foreign investments and protect their revenue base, most countries including India have signed bilateral tax treaties with each other called Double Taxation Avoidance Agreement, herein after referred to as DTAA, to provide investors tax concession. These treaties are based on two models: the United Nations (UN) model conventions and the Organization for Economic Co-operation and Development (OECD) model convention.
The foremost purpose of DTAA is to avoid double taxation on the same income in two different countries and prevent fiscal evasion of taxes on income and capital gains and encourage mutual trade and investment.

In exercise of powers under section 90[1] of the Income Tax Act, 1961, our Central Government has signed 88 DTAAs, but only 85 are in force. Most of India's DTAAs follow the OECD model convention (2008). A classic example of India's well-known DTAA would be the India – Mauritius DTAA.

What are LOB Clauses? Why did they come in to force?

With the introduction of DTAAs, many companies, in order to minimize tax liability or many a times evade tax liability completely, started exploiting treaty laws. For example, a resident in Mauritius could avoid tax on capital gains in India (the source state) as it was not a resident in India as well as avoid tax on

1 *"90. Agreement with foreign countries.*
(1) The Central Government may enter into an agreement with the Government of any country outside India-
(a) for the granting of relief in respect of income on which have been paid both income- tax under this Act and income- tax in that country, or
(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or
(c) for exchange of information for the prevention of evasion or avoidance of income- tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or
(d) for recovery of income- tax under this Act and under the corresponding law in force in that country, and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India under sub- section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

(Explanation omitted as not relevant)

capital gains in Mauritius (residence state) because in Mauritius, residents were not taxed on capital gains.

Therefore, in order to prevent abuse of treaty benefits and treaty shopping, countries have revised their tax treaties to include an anti-abuse provision called the limitation of benefit clause, herein after referred to as LOB clause. As the name suggests, this provision limits the benefits of favorable tax treaties.
For example, under the India – Mauritius treaty, tax on gains from alienation of shares arising between 1st April 2017 and 31st March 2019 cannot exceed 50% of the tax rates applicable on such gains in the state of residence of the company whose shares are being alienated. As a result of this, numerous companies were incorporated to exploit loopholes provided in tax laws of the DTAA. To counter misutilization of this benefit, the DTAA was renegotiated to include a LOB clause, which states that the benefit will not extend to residents of the contracting State if it's affairs are primarily set up for taking advantage of the benefit of this treaty.

Easy understanding of LOB clause of India's significant DTAAs

1. **INDIA - MAURITIUS DTAA**

The India – Mauritius DTAA was signed back in 1983. Historically, Mauritius is considered a "tax haven" as residents in Mauritius were not taxed on capital gains. Hence, companies starting routing their investments through Mauritius to evade tax on capital gains. At this point, it is pertinent to state that the Hon'ble Supreme Court of India in ***Union of India vs Azadi Bachao Andolan***[2] held that in the absence of any express or implied provision there is nothing to prevent the nationals of "third States" from claiming right under the treaty (i.e.) in the absence of a limitation of benefit clause in the treaty, treaty shopping was valid. Therefore, to prevent such treaty shopping, both countries renegotiated the treaty and included the LOB clause w.e.f 1st April 2017.

"Article 27A – LIMITATION OF BENEFITS," reads as follows:

> *"1. A resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention.*
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> *2. A shell/conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention. A shell/conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.*

2 263 ITR 706 SC

3. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less 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.

4. A resident of a Contracting State is deemed not to be a shell/conduit company if:

(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."

The clause provides that a resident of Mauritius or a shell company claiming to be resident of Mauritius will not allowed to avail the benefits under this treaty if it was set up merely to take advantage of the benefits. The sub-clause(3) further provides that company will be deemed to be a shell company if it's annual expenditure on operations Mauritian Rs.15,00,000 in Mauritius or Indian Rs. 27,00,000 in India. Sub-clause(4) provides that a company will not be deemed to be a shell company if it is listed in a recognized stock exchange in one of the Contracting States.

As a result of the controversy on treaty shopping that cropped up in the ***Azadi Bachao Andolan*** case, many countries like Singapore, UK and US renegotiated their treaties to include the LOB clause.

2. INDIA - SINGAPORE DTAA

India and Singapore signed the treaty on January 24, 1994. In 2005 the treaty was amended to include the LOB clause.

"Article 24 – Limitation of Relief," reads as follows:

"1. Where this Agreement provides (with or without other conditions) that income from sources in a Contracting State shall be exempt from tax, or taxed at a reduced rate in that Contracting State and under the laws in force in the other Contracting State the said income is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the exemption or reduction of tax to be allowed under this Agreement in the first-mentioned Contracting State shall apply to so much of the income as is remitted to or received in that other Contracting State.

2. However, this limitation does not apply to income derived by the Government of a Contracting State or any person approved by the competent authority of that State for the purpose of this paragraph. The term "Government" includes its agencies and statutory bodies."

This means that where income from sources in India is exempt from tax or taxed at a reduced rate in India under the laws in force in the Singapore the said income is subject to tax, the exemption or reduction of tax to be allowed under this Agreement in India shall apply to so much of the income as is remitted or received in India and vice – versa. The said provision proves to be highly beneficial to Singapore residents as in Singapore there is no tax on capital gains. In order to prevent abuse of this benefit, the treaty was amended to add, Article 24A, another LOB clause with effect from 1st April 2007.

Article 24A reads as follows:

"1. A resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement if its affairs were arranged with the primary purpose to take advantage of the benefits in the said paragraph 4A or paragraph 4C of Article 13 of this Agreement, as the case may be.

2. A shell or conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement. A shell or conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.

3. A resident of a Contracting State is deemed to be a shell or conduit company if its annual expenditure on operations in that Contracting State is less than S$200,000 in Singapore or Indian Rs.5, 000,000 in India, as the case may be:

(a) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12- month periods in the immediately preceding period of 24 months from the date on which the gains arise;

(b) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.

4. A resident of a Contracting State is deemed not to be a shell or conduit company if:

(a) it is listed on a recognised stock exchange of the Contracting State; or

(b) its annual expenditure on operations in that Contracting State is equal to or more than S$200,000 in Singapore or Indian Rs.5,000,000 in India, as the case may be:

(i) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12-month periods in the immediately preceding period of 24 months from the date on which the gains arise;

(ii) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.

5. *For the purpose of paragraph 4(a) of this Article, a recognised stock exchange means:*

(a) in the case of Singapore, the securities market operated by the Singapore Exchange Limited, Singapore Exchange Securities Trading Limited and The Central Depository (Pte) Limited; and

(b) in the case of India, a stock exchange recognised by the Securities and Exchange Board of India."

This means that the resident of Singapore set up solely for the purpose availing this benefits or a shell company (a company with zero business operations) that claims to be a resident of Singapore will not be entitled to the benefits under this treaty. The clause further states that a company will be deemed to be a shell company if it's annual expenditure on operations in the immediately preecing 24 months from the date on which the gains arise is less than Singapore $200,000 or Indian Rs.50,00,000 in the respective State. Sub-clause(4) and (5) provide that a company will not be deemed to be a shell company if it is listed in a recognized stock exchange in one of the Contracting States. Incase of Singapore, the securities market operated by the Singapore Exchange Limited, Singapore Exchange Securities Trading Limited and The Central Depository (Pte) Limited and incase of India, stock exchange recognised by the Securities and Exchange Board of India.

3. INDIA – UNITED KINGDOM (U.K.) DTAA

The Indo – UK Convention for avoidance of double taxation and prevention of fiscal evasion w.r.t taxes on income and capital gains came in to force on 26th October 1993. The two Governments, on 30th October 2012, signed a protocol vide which they amended the treaty to include Article 28C – LOB clause w.e.f 27-12-2013.

"Article 28C – LIMITATION OF BENEFITS," reads as under:

“1. Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.

2. Where by reason of this Article a resident of a Contracting State is denied the benefits of this Convention in the other Contracting State, the competent authority of that other Contracting State shall notify the competent authority of the first-mentioned Contracting State.”

This provision means that the benefits under this treaty will not be available to a resident of India / U.K. if the main purpose or one of the purposes of creation or existence of the resident or transaction undertaken by the resident is merely to obtain benefits under the treaty. However, to safeguard the assessee from application of the LOB clause by the tax authorities in an prejudicial manner, sub-clause(2) of the LOB clause provides that if the resident of a contracting state is denied benefits in the source state, the competent authority of the source state will have to notify the competent authority the residence state of the same.

4. INDIA – UNITED STATES (U.S.) DTAA

The agreement for avoidance of double taxation and prevention for fiscal evasion w.r.t taxes on income was signed on 12th September 1989 and came to force in 1990. This treaty is slightly different from the other treaties entered by India as it follows the United Nations Model Convention. With the aim to prevent third country residents from treaty shopping, India and US signed a protocol amending the treaty to include the LOB clause.

Usually, in U.S., 30% is deducted as tax on income of non-residents earned from U.S. sources. The tax treaty provides for relief from taxation or taxation at a reduced rate to non-residents who qualifies for the benefits. To qualify for the benefits, the non-resident will have to satisfy the tests mentioned under the LOB clause.

“Article 24 – LIMITATION OF BENEFITS,” reads as follows:

“1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

(a) more than 50 per cent of the beneficial interest in such person (or in the case of a company, more than 50 per cent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other

individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States ; and

(b)the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not resident of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or citizens of the United States.

2. The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).

3. The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

(a) in the case of United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934 ;

(b) in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contracts Regulation Act, 1956 ; and

(c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines."

The tests provided under Article 24:

Test 1: Ownership – base erosion test:

more than 50% of the company's shares (in value) must be held by the residents of the contracting state in which the company is a resident or by citizens of U.S.; and

not more than 50% of the income of the company is paid to non residents of the same country as the company or citizens of U.S.

Example: U.S. and Germany are treaty partners and Germany and country A are treaty partners. Country A resident could lend funds to a German Corporation in Germany which can relend it to U.S. The U.S source interest, which is the income of the German corporation, would be exempt from U.S. withholding of tax under Article 11 of the US – Germany tax treaty. The German income would be subject to German's income tax, the taxable amount can be reduced to nearly zero by the deductible interest being paid to the resident (lender) in Country A. Under the tax treaty between Germany and Country A, that interest is exempt from German tax. Thus, U.S treaty benefit w.r.t U.S source income would be enjoyed by the resident in Country A (third country).

Exception – the provisions of paragraph 1 will not apply if the resident of a contracting state fulfills one of the below mentioned tests.

Test 2: Active trade or business test:

a. A company being a resident in a contracting state must be engaged in active trade and business in that country

b. the activities of it's trade and business must be substantially in relation to the activities of the payer in the other contracting state

c. the income must be got in connection with that trade or business

Example: A is a holding company in India owned by a resident of another country. Company A has participation of 60% in company B that is a resident in India. Indian Company B manufactures and sells mobile phones and phone accessories in India. C a resident company in U.S. manufactures and sells mobile phones in USA. The U.S. Company C purchases mobile accessories from the Indian company B for sale and distribution in U.S. Indian company B's activities are substantially in relation to the activities of the U.S. Company C. Payment is made by the U.S Company C to Company A in lieu of interest on loan and dividend on shares. The income received by the Company A from the U.S. Company C is in relation with A's active and substantial to the trade or business (through Company B) in India. Therefore, treaty benefits can be obtained by the Company A w.r.t payments from the U.S Company C.

Test 3: Stock exchange test:

A company must be a resident of India / U.S. It's principal class of shares must be substantially and regularly traded in a recognized stock exchange.

Incase of India – a stock exchange recognized by the Central Government.

Incase of U.S. - NASDAQ or stock exchange registered with the Securities and Exchange Commission.

Bottom Line

The LOB clause in tax treaty varies from country to country. Treaties of some countires like Mauritius, Singapore, U.K. focus on the purpose of creation of the resident or the transaction entered in to and deny benefits where the reason for creation or transaction was merely to take benefits of treaty laws. Treaties with countries like U.S. focus more on the characteristics of the party seeking the benefit. The introduction of LOB clause in India's DTAAs makes it evident that the Indian Government is taking the required steps to fight "treaty shopping", which is limiting the ability of third states from obtaining benefits under treaty laws.