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# Double Taxation Avoidance Agreement: A Way to Evade Tax

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**ABSTRACT**

*Every businessman, every company and every investor are all under a constant search of devising a process of saving tax. No one wants to give their hard earned income to the government because for them, they can multiply that money manifold through investment and that will lead to their benefit. One of the processes devised for it is through the help of tax havens and Double Tax Avoidance Agreements (DTAA). With the advent of Globalisation and expansion of businesses the entities come to different countries to do trade, the now arises is which government will tax them? Will there be double taxation? Will the person pay such tax? No, and so for this, the concept of DTAA was developed. But the picture does not end here and as any person will want, the people (investors) found a way to escape this liability of tax and there it started tax evasion. The governments, when they took notice of it, were in a fix as to how to avoid these and hence took steps to curb it. But are the steps taken by the authorities sufficient in dealing with this problem? To find answers to these questions this paper examines the role of in facilitating the Foreign Direct Investments and the misuse of this DTAA in generation of black money and tax evasion by round tripping and treaty shopping, the measures taken by government and their effectiveness and the suggestions by researcher to curb this problem.*

***Key words:*** *DTAA, FDI, Treaty Shopping, Round Tripping, OECD, BEPS.*

## I. INTRODUCTION

In a world of globalization where the concept of borders is fading and people from different geographical areas are coming together to conduct business at different places, is it feasible for them to pay taxes again and again just because of expansion of their business? Will this double taxation encourage them to expand their businesses worldwide? Will the businessman be willing to pay double tax on same income? The answer to all of these questions for anyone, even with no knowledge of law, will be a big NO. Why? Because tax is a compulsory liability imposed by the government and no one likes to pay tax out of their hard earned income; on the top of it, paying double taxes for the same work just for the sake of working in the other country,

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thereby reducing the income will not work for anyone. This will not only lead to people being discouraged to expand their business globally but will also encourage them to adopt tactics to evade taxes and hence generating black money.

So how do we prevent this double taxation and at the same time promote business expansion? For this the government of different countries have devised the concept of Double Taxation Avoidance Agreement (for brevity "DTAA")

***What is Double Taxation?***

When the income of a person or entity twice for the same income that is generated in the same jurisdiction then such taxation is known was double taxation.[2]

*For example*: X (from country ABC) is conducting his business in country PQR and the income generated from the business done in country PQR is being taxed in PQR due to being source country of income generation but the same income is also being taxed in country ABC being his own country then such tax charged upon him will be called double taxation.

***What is DTAA?***

As the name suggests, DTAA is an agreement (can also be called as a treaty) entered into by two countries in order to relieve tax payers from paying double taxes in source country[3] and resident country[4].

These treaties are based in large part on the "United Nations Model Double Taxation Convention between Developed and Developing Countries[5] (United Nations Model Convention)" and the "Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[6] (OECD Model)."

India being the main attraction of investors now-a-days have many businesses coming in from different countries and hence for avoiding this problem of double taxation, India has signed DTAA with more than 80 countries till now. First one was signed with Greece[7] in 1965 and the

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[2] Kagan, J. (2022, June 9). *What Double Taxation is and How It Works*. Investopedia. https://www.investopedia.com/terms/d/double_taxation.asp.

[3] ARNOLD, B. J. (2020, June 24). *An introduction to tax treaties* . United Nations. https://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf. Defines "Source Country" as: "State in which the income arises or has its source"

[4] Ibid. (p-7) Defines "Resident Country" as: "the State in which the taxpayer is resident"

[5] United Nations Model Double Taxation Convention between Developed and Developing Countries (2021) https://financing.desa.un.org/sites/default/files/2023-05/UN%20Model_2021.pdf.

[6] Model Tax Convention on Income and on Capital (2017) https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

[7] Ministry of Finance, of. (2016, October 26). *New Revised Double Taxation Avoidance Agreement (DTAA) between India and Republic of Korea comes into force with effect from 12th September, 2016; Will have effect in India in respect of income derived in fiscal years beginning on or after 1st April, 2017.M*. New Revised Double Taxation Avoidance Agreement (DTAA) between India and Republic of Korea comes into force with effect from

latest being Chile in 2023.[8]

***Types of DTAA:***

DTAA by a country include income related to the following:

1. Salary
2. Capital gains
3. Savings
4. Services
5. Property
6. Fixed deposit account

DTAA regarding these heads can be of two types namely:

1. An agreement that covers all types of income as mentioned above.
2. An agreement focusing on particular type or types of income.

***Duration and rates under DTAA:***

DTAA can be in force until the parties to agreement terminate it or the time period of the agreement may be specified in the agreement itself, for example, the DTAA agreement with USA specifies the time period of 10 Year within the agreement itself.

Rates in DTAA may vary from country to country and is subject to the agreement between them.

*What are the methods of eliminating double taxation*?

There are 2 methods of eliminating double taxation through the DTAA.

***1.*** *Exemption Method*[9]

Under this method the taxpayers are exempt from paying tax in the resident country. However, the total tax on the aggregated income will have to be paid in the source country.

12th September, 2016; will have effect in India in respect of income derived in fiscal years beginning on or after 1st April, 2017. https://pib.gov.in/newsite/printrelease.aspx?relid=151974.

[8] Ministry of Finance. (2023, May 3). *Agreement Between Republic of India and Republic of Chile*. Income Tax Department. https://incometaxindia.gov.in/Pages/communications/index.aspx.

[9] Anonymous. (2023, March 20). *Double Tax Avoidance Agreement – Meaning and Advantages*. DTAA - Advantages of Double Taxation Relief, Avoidance Agreement. https://www.adityabirlacapital.com/abc-of-money/advantages-of-double-taxation-agreement.

This method encourages taxpayers to make cross-border investments in the home country without worrying about taxation because foreign income is taxed as very low rates and hence such countries are called tax havens

Some of the countries implementing this method are: The Cayman Islands, The Bahamas, and Cyprus.

**2.** *Foreign Tax Credit Method*[10]

As per this method, the taxpayers are supposed to pay the taxes in the country that they are residing in (resident country), regardless of where it arises from (source country). The resident country then allows a tax credit in that country after the tax has been paid in the country in which the revenue was paid. In this method, the tax paid in one country is balanced and offset against the tax liability that arose in another country.

## LITERATURE REVIEW

*Tushar Mudgil* (2019) in his article on "Double Taxation Avoidance Agreement", *Divya Singhvi (2021)* and in her article on "DTAA - Double Taxation Avoidance Agreement: Definition, Types, and Benefits" and *Taxblock India Pvt. Ltd. (2022) in their article on "benefits of DTAA"* has rightly pointed out the advantages of having DTAA that is it helps in tax exemption, gives tax credits, reduces the risk of tax invasion, lower the risk of tax withholding and since foreign institutional investors (FII) play a very influential role in India's investment market attracts investment. But they have failed to analyse the various disadvantages of it because these provisions under the tax treaties between the countries can be used in a lot of ways to avoid tax.[11]

The global motivation to escape from the clutches of double taxation led to the emergence of concept of DTAA which had some unexpected negative outcomes *Easson (2000)*. The "Double Taxation Avoidance Agreement" may lead to treaty shopping. In order to avoid the source country which is withholding the outgoing income earned by resident country the money is routed through a third country (country other than source country) which has more favourable DTAA and hence avoiding paying more taxes *(Dyreng et al. 2015).* This treaty shopping is one of the major concerns as it creates opportunity for "base erosion and profit shifting (BEPS)."[12] *(OECD 2015)*

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[10] Ibid.

[11] See the Commentary on Article 1 of the *UN Model Convention*, paragraphs 40-99, for a description of several of the common treaty abuses.

[12] OECD. (n.d.). *What is BEPS?* https://www.oecd.org/tax/beps/about/. Defines BEPS as: "Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches

Information provided by OCED on aggregate stocks and inflows and outflows of bilateral FDI 1982-1992 shows that these new tax treaties have a strong negative impact on FDI ***Blonigen and Davis (2004). Egger et al. (2006),*** focusing on difference in the differences in DTAAs of countries and using different matching estimators in bilateral outward FDI after DTAA is signed, made the study of period from 1985-2000 and it shows that DTAA do not have any effect on FDI. ***Owens (1962), Davis (2004), Baker (2014)*** have argues that we can easily achieve what we want through DTAA by unilateral tax policies because most countries, even without DTAA already offer tax credits and exemptions and hence for avoiding double taxation treaties have limited role. ***Dreßler (2012), Weichenrieder (2010) and Weyzig (2013)*** have analysed the effect of DTAAs on FDI when there is treaty shopping being done. ***ECOSOC (2006)*** has analysed the issues of treaty shopping and has given counter measure of the same. David G and ***Duff (2020)*** has analysed the responses to treaty shopping.

***Buckley et al (2007)*** in his article has talked about routing of capital flows the role of tax havens in facilitating the same, and that how FII escape from taxes and regulations with the help of tax havens, how value seeking is done by FII in the terms of capital market and what all are the legal services are present in these tax havens, he also talked as to how underdevelopment of financial and legal institutions in many developing countries, leads to the promotion of foreign investments by tax havens which ultimately leads to round tripping.

Even so, there seems to be an agreement on the observation that tax havens have a negative impact in every economy and, which can be seen by the growing initiatives by governments of many countries and by various international organisations. For example, the Organisation for Economic Cooperation and Development's initiative on Harmful Tax Practices ***(OECD 1998)*** has gathered significant momentum and resulted in the Base Erosion and Profit Shifting (BEPS) Project which is backed by G20 countries. BEPS project is aimed at curbing various kinds of tax avoidance practices used by investors ***(OECD 2013).*** To address the secrecy aspects of the tax havens, OECD has restructured the Global Forum on Transparency and Exchange of Information for Tax Purposes, which aims to facilitate a better and effective framework for exchange of information between jurisdictions.

## RESEARCH METHODOLOGY

***Research Design:*** The purpose of this study is to analyse the effect of DTAA on FDI on India and the role of DTAA in treaty shopping , this research provides a quantitative assessment of

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in tax rules to avoid paying tax. Developing countries' higher reliance on corporate income tax means they suffer from BEPS disproportionately."

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regarding FDI (inward) that are directed through a third country.

The DTAAs of some selected countries with India are then gauged to find as to what are the tax rates that are applicable on the FDI (inward) coming from such countries. The aim of the study is to determine whether there exist any linkages between DTAA and routing of FDI (inward) to India through that country. The researcher also seeks to analyse the measures that can be tackle the problem of treaty shopping.

***Research Approach:*** This paper uses qualitative data. The approach towards the study will be an analysis of secondary data available on the web, through various reports like that of ECOSOC and OCED, IBFD Online Tax Platform and the articles of various scholars. In order to analyse the investment from resident country to source country, researcher will analyse the bilateral FDI (inward) from 2005 to 2012 from UNCTAD.

## II. Analysis and interpretation

### *DTAA and FDI in India:*

**Foreign Direct Investment (FDI)**[13] for India is where the investors from other countries come and invest in India for a long term purpose. FDI is a beneficial tool for technology transfer and boosting the economy, promotion if international trade of the country and access to foreign markets.

Since 1991 (after introduction of LPG) India has been trying to attract FDI and has provided many incentives for attracting the same like setting up SEZs (Special Economic Zones), import duty exemption, income tax exemption, rebate of VAT (Value added tax) on export etc.[14] One such policy for increasing FDI was DTAA. India has entered into 169 agreements till now with various countries in various aspects of DTAA.[15]

Even though these agreements were for promoting trade and investments and increasing FDI by they were criticized for they were facilitating treaty shopping[16] and round tripping[17] due to

[13] OCEDiLibrary. (n.d.). *Foreign Direct Investment (FDI)*. OECD iLibrary. https://www.oecd-ilibrary.org/finance-and-investment/foreign-direct-investment-fdi/indicator-group/english_9a523b18-en. Defines "Foreign Direct Investment (FDI)" as: "Foreign direct investment (FDI) is a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy"

[14] The incentives mentioned may not necessarily for the purpose of FDI only and may be given in domestic investments too.

[15] Income Tax Department. (n.d.). *Income Tax Department*. https://incometaxindia.gov.in/pages/international-taxation/dtaa.aspx

[16] OECD. (2023, March 21). *Sustained progress demonstrated in the latest OECD peer review results ...* https://www.oecd.org/tax/sustained-progress-demonstrated-in-the-latest-oecd-peer-review-results-on-the-prevention-of-tax-treaty-shopping.htm.

[17] OECD. (n.d.-a). *Glossary of foreign direct investment terms and definitions - OECD*. https://www.oecd.org/daf/inv/investment-policy/2487495.pdf. (p-13)"

high FDI inflows from tax havens[18] like Singapore, Mauritius, Cyprus etc. Due to these the government of India amended its policies and after several negotiations, it amended its treaties with these countries in 2016.

***FDI from tax havens due to DTAA, a trend:***

India saw a steady increase in the FDI in late 1900s but the breakaway was in 2006-2007 where the FDI suddenly shoot up to $ 22 Billion from $9 Billion in 2005-2006 and since then the FDI continued to rise, making India, globally, the largest recipient of FDI, the reasons for this were:

1. Adoption of International norms for reporting FDI and including re-invested capital in addition to other capital in FDI statistics.
2. Rising trends in global FDI inflows.
3. Change in government policies like SEZ etc.

But here the role of Mauritius and Singapore was rising significantly in inward FDI which was nearly 40% of total FDI and hence it received considerable attention. Apart from that, USA also became the top contributor of FDI in India for FDI based on their home country. Interestingly however, the next biggest contributors of FDI in India were the companies based in India- not only that but their contribution far outweighed the contribution of other major economies like UK, Japan and Germany. The above findings do reinforce the possibility of 'round-tripping'[19] to some extent. In view of the complex nature of fund raising and the near impossibility for researcher to obtain the required information, it would not be possible to pinpoint the exact source and nature of the funds.

We can say that India's controlled FDI was likely to be a combination of funds raised overseas and round-tripping. There was huge increase in Illicit Financial Flows (IFFs) moving out of India in 2004-14 – from $19 billion in 2004 to $83 billion in 2013. India's outward direct investment (ODI) flows also increased from $2 billion in 2004 to $12 billion in 2014.[20]

Analysing the data we can see that most of the FDI that were being invested in India were first shifted to different entities in another jurisdictions and then invested in India. This process was not necessarily done in one step or with the routing to only one entity or jurisdiction but involved multiple of them to remove traces. This use of tax havens shows used of subsidiaries by investors which not only minimized the tax rates but also tax payments. This also lead to

[18] IMF, eLibrary. (n.d.). *Tax Havens explained - IMFSG*. IMF eLibrary. https://www.elibrary.imf.org/downloadpdf/journals/022/0013/001/article-A011-en.pdf.
[19] A report by Export-Import Bank of India (2014) has noted earlier that "Round-tripping is a major reason for Mauritius being a source as well as destination for FDI", however it doesn't give any estimates for the same.
[20] Based on UNCTAD (2016): World Investment Report, Annex Table 02

establishment of a lot of shell companies as in tax havens there is minimal cost of incorporation of these companies plus tax benefits which is cherry on the top of the cake.

All of these lead to formation of "SIT (Special Investigation Team)" by GoI on direction of Supreme Court for looking into the matter of shell companies.[21] SIT recommended provisions for detection of shell companies but these were applicable only in cases of domestic companies as foreign company being a shell company is hard to identify which lead to coming to ground zero for FDI that were there due to DTAA.

***Recent Developments:***

India has amended its treaty with Mauritius, Singapore and Cyprus in order to curb the problem of treaty shopping and round tripping as it aims towards withdrawal of "zero effective tax rates" for short term capital gains. The amended treaty is focused towards reducing of routed funds from the above mentioned countries. But since these amendments do no significantly affect the FDI routing since they are related to capital gains and hence the investors can route the income as income under the head of financial services, technical services, royalties and interest has no changed. Also, it is not necessary for the investors to directly invest in the country, they can always route it through other tax havens which have not come to agreement with India yet.

Another development to be noted here is that India has become a signatory to BEPS which is constantly working on curbing the practice of round tripping and treaty shopping.

Another development in this field is related to increasing development in exchange of information between the countries in order to deal with the tax evasion. This gives large data to the governments to analyse the information about taxpayers and their assets in foreign county through which round tripping takes place.

## III. CONCLUSION AND SUGGESTION

With the continuous work in the field of taxation, no doubt there has been a significant change in the taxation regime and the governments are aiming towards transparency so that the problem of tax evasion and generation of black money can be avoided but there are always people who find loopholes. The biggest problem in the field of international taxation and hence the problems arising in DTAA is the lack of information available to countries due to which they are unable to assess the round tripping by their own taxpayers.

[21] OECD. (n.d.-b). *Special Entities*. OECD iLibrary. https://www.oecd-ilibrary.org/. Defines "Shell Companies" as: "The term shell is used to refer to a company that is formally registered, incorporated, or otherwise legally organised in an economy but which does not conduct any operations in that economy other than in a pass-through capacity."

**Suggestion**: From all the above analysis the research can to the idea that the countries should come together and try to develop an internationally sound common system of taxpayers whereby the taxpayers in every country must be allotted a unique number (just like PAN in India) and the database of all these taxpayers should be regularly fed to this system. The system must have all the sources of income of tax payer at one place under the head of that unique number so that information about an individual or entity can accessed at only one click for analysis in order to keep track of the activities of tax payers and their association with different companies so that the source of their income is visible and hence when the investment is made by a FII or entity then the source and connection can always be traced from that information.

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