TAX HAVENS AND MONEY LAUNDERING IN INDIA

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TAX HAVENS AND MONEY LAUNDERING IN INDIA

Abstract: Offshore tax havens and financial centres, many of which are located within small, economically developing island nations, have long been recognized for providing highly favourable financial advantages to foreign corporations and individuals. These offshore havens, however, have recently become the centre of intense international criticism given their role in eroding foreign tax revenues by offering markedly low tax rates and facilitating domestic tax evasion and money laundering through strict financial secrecy laws. There is lot of dialogue that is happening in the international taxation sphere as to tax havens, how to deal with the issue of tax competition that is being thrown up by the tax havens, policy framing and diplomatic endeavours to make a way around this, but at the same time there is also views prevalent that the taxation rate of the developed countries, which have become much favourable over the decades, owes much to the existence of the tax havens, their overwhelming influence upon the taxation structure of all the countries across the world. Globalization has resulted in the erosion of business boundaries. However, with law enforcement still nationally implemented, the freedom gained through globalization is being abused from such acts as tax evasion. Tax evasion undermines a government's ability to raise revenue whereby tax abusers shift financing burdens onto others. This forces governments to cut back on social and infrastructure projects. Although tax evasion drains a substantial amount of revenue from the economy, it is spread across the entire population, and thus the direct effect on any individual citizen is minimal. This, however, should not undercut the subtle injustices suffered by citizens. It is such conditions that led the Organization for Economic Co-operation and Development (OECD) to address the global issue of harmful tax practices. So, in this paper we try to show what are the current regulations dealing with Money laundering in India and what are the challenges faced by the framework and the possible effective solution to the challenges.

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TAX HAVENS AND MONEY LAUNDERING IN INDIA

CHAPTER 1: INTRODUCTION

The "tax havens" are locations with very low tax rates and other tax attributes designed to appeal to foreign investors. Tax haven countries receive extensive foreign investment, and, largely as a result, have enjoyed very rapid economic growth over the past 25 years. Over the last twenty years, startling advances in technology and the telecommunications revolution have made it easier to access offshore facilities - so much so, that today's offshore industry has developed a major global business, spanning all quarters of the world, involving, in one way or another, approximately half of the world's financial transactions by value.[1] More than 150,000 offshore corporations are formed each year.[2]

These offshore havens, however, have recently become the centre of intense international criticism given their role in eroding foreign tax revenues by offering markedly low tax rates and facilitating domestic tax evasion and money laundering through strict financial secrecy laws.[3] There is lot of dialogue that is happening in the international taxation sphere as to tax havens, how to deal with the issue of tax competition that is being thrown up by the tax havens, policy framing and diplomatic endeavours to make a way around this, but at the same time there is also views prevalent that the taxation rate of the developed countries, which have become much favourable over the decades, owes much to the existence of the tax havens, their overwhelming influence upon the taxation structure of all the countries across the world[4].

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[1] Hines, J. R., Jr. and E. M. Rice (1994) "Fiscal Paradise: Foreign Tax Havens and American Business" *Quarterly Journal of Economics*.

[2] An IBC is an entity that cannot trade or be involved in any activity in the country of incorporation, with the exception of payment of government fees, payments for the services of lawyers, and accountants, if necessary. Such companies are exempt from all types of taxes. An Offshore tax shelter IBC can be involved in activities with another offshore company incorporated in the same jurisdiction. There is no exchange control restriction on such companies. Confidentiality of your activities is guaranteed also, which is one of the main attractions that offshore havens offer.

[3] Richard A. Johnson, Why Harmful Tax Practices Will Continue After Developing Nations Pay: A Critique of the OECD's initiatives against harmful tax competition, Boston College Third World Law Journal Spring, 2006, 26 BCTWLJ 351

[4] Taxes are much lower today than they were 30 years ago. In 1980, top personal income tax rates in OECD countries averaged more than 67 percent, and corporate rates that year averaged nearly 50 percent. Top personal tax rates now average only about 40 percent, and corporate rates have been reduced to an average of about 27 percent. It is largely due to globalization. Governments are cutting taxes because they fear that jobs and investment will flee across national borders. Tax havens, by providing a safe refuge for people seeking to dodge confiscatory tax rates, have played a critical role in these positive developments. Better to get some revenue with modest tax rates, lawmakers have concluded, than impose high tax rates and lose out.

CHAPTER 2: TAX HAVENS

Tax Havens in Theory and Practice

Tax havens are well positioned to benefit from the considerable international mobility of business investment and the associated tax base.[5] There is ample reason to expect their low tax rates to influence both the investment and the tax avoidance activities of foreign investors, and an extensive literature documents the magnitudes of the effects of low tax rates.[6] With respect to investment, tax policies are obviously capable of affecting the volume and location of FDI since; all other considerations equal, higher tax rates reduce after-tax returns, thereby reducing incentives to commit investment funds. Tax havens attract foreign investment not only because income earned locally is taxed at favorable rates, but also because tax haven activities facilitate the avoidance of taxes that might otherwise have to be paid to other countries. One way that tax havens facilitate tax avoidance is by permitting taxpayers to reallocate taxable income from high-tax to low-tax jurisdictions. Multinational firms typically can benefit by reducing prices charged by affiliates in high-tax countries for items and services provided to affiliates in low-tax countries. OECD governments require firms to use transfer prices that would be paid by unrelated parties, but enforcement is difficult, particularly when pricing issues concern unique or proprietary items such as patent rights.

Multinational firms can structure a variety of transactions – intra-firm debt, royalty payments, dividend repatriations, and intra-firm trade – in a manner that is conducive to tax avoidance.[7] Finally, tax haven operations can be used to avoid triggering home-country taxes that would otherwise be due on repatriated income. Placing a tax haven company at the top of the ownership chain of a firm's foreign operations creates opportunities to redeploy income between foreign jurisdictions without receiving the income in the firm's home country and thereby producing a home

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[5] Tax havens may serve different purposes for business investors than they do for individual and trust investors. The analysis that follows concerns only the business uses of tax havens, which in any case greatly exceed their use by individual investors. The sum of incomes earned in Panama, Bermuda, all Caribbean and West Indian countries, Ireland, Luxembourg, Switzerland, Hong Kong and Singapore by American individuals filing forms 1116 and 2555 (which entails some double counting, as the same individual may file both) in 2001, and trust income earned in 2002, was $7.4 billion. By contrast, the controlled foreign corporations of American corporations reported $57.3 billion of after-tax earnings and profits in these countries in 2002. Masters, M. and C. Oh (2006) "Controlled Foreign Corporations, 2002" *Statistics of Income Bulletin*,

[6] Devereux, M. P. (2006) "The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence" Mimeograph, University of Warwick.

[7] Ibid

country tax obligation. The resulting tax savings can be substantial,[8] contributing to the value of tax haven operations.

Concern over the possible implications of international tax competition has prompted many governments to consider international cooperative efforts designed to preserve their abilities to tax mobile business income.[9] Despite enthusiasm expressed by some participants, differences of viewpoint and interest make international tax agreements involving more than two countries notoriously difficult to conclude. The most ambitious and effective multilateral tax agreement to date is an effort of the Organization for Economic Cooperation and Development (OECD).[10] The OECD in 1998 introduced what was then known as its Harmful Tax Competition initiative,[11] and is now known as its Harmful Tax Practices initiative. The purpose of the initiative was to discourage OECD member countries and certain tax havens outside the OECD from pursuing policies that were thought to harm other countries by unfairly eroding tax bases. In particular, the OECD criticized the use of preferential tax regimes that included very low tax rates, the absence of effective information exchange with other countries, and ringfencing that meant that foreign investors were entitled to tax benefits that domestic residents were denied.

Tax Haven Criteria

The *Organization for Economic Co-operation and Development* (OECD) identifies four key factors in considering whether a jurisdiction is a tax haven. The first is that the jurisdiction imposes no or only nominal taxes. The no or nominal tax criterion is not sufficient, by itself, to result in characterisation as a tax haven. The OECD recognises that every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate. An analysis of the other key factors is needed for a jurisdiction to be considered a tax haven. The three other factors to be considered are:

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[8] Altshuler, R. and H. Grubert (2003) "Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy" *Journal of Public Economics*

[9] Desai, M. A., C. F. Foley and J. R. Hines Jr. (2006a) "The Demand for Tax Haven Operations" *Journal of Public Economics*

[10] Hines, J. R., Jr. (2006) "Will Social Welfare Expenditures Survive Tax Competition?" *Oxford Review of Economic Policy.*

[11] OECD (1998) *Harmful Tax Competition: An Emerging Global Issue* Paris: OECD.

- Whether there is a lack of transparency
- Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation.
- Whether there is an absence of a requirement that the activity be substantial

Transparency ensures that there is an open and consistent application of tax laws among similarly situated taxpayers and that information needed by tax authorities to determine a taxpayer's correct tax liability is available (e.g., accounting records and underlying documentation).

With regard to exchange of information in tax matters, the OECD encourages countries to adopt information exchange on an "upon request" basis. Exchange of information upon request describes a situation where a competent authority of one country asks the competent authority of another country for specific information in connection with a specific tax inquiry, generally under the authority of a bilateral exchange arrangement between the two countries. An essential element of exchange of information is the implementation of appropriate safeguards to ensure adequate protection of taxpayers' rights and the confidentiality of their tax affairs.

The no substantial activities criterion was included in the 1998 Report as a criterion for identifying tax havens because the lack of such activities suggests that a jurisdiction may be attempting to attract investment and transactions that are purely tax driven. In 2001, the OECD's Committee on Fiscal Affairs agreed that this criterion would not be used to determine whether a tax haven was co-operative or unco-operative.

CHAPTER 3: REGULATION OF TAX HAVENS UNDER OECD

Governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce the tax that would otherwise be payable to them. A variety of counteracting measures are currently used by countries that wish to protect their tax base against the detrimental actions of other countries that engage in harmful tax competition. The manner in which these measures apply varies widely from country to country.[12]

[12] OECD Report on *HARMFUL TAX PRACTICES: AN EMERGING GLOBAL ISSUE*, 1998.

These measures are typically implemented through unilateral or bilateral action by the countries concerned. A rigorous and consistent application of existing tools can go a long way towards addressing the problem of harmful tax competition. There are limits, however, to such a unilateral or bilateral approach to a problem that is essentially global in nature. First, the jurisdictional limits to the powers of a country's tax authorities restrict the ability of these authorities to counter some forms of harmful tax competition. Second, a country may believe that taxing its residents in a way that neutralises the benefits of certain forms of harmful tax competition will put its taxpayers at a competitive disadvantage if its action is not followed by other countries. Third, the necessity to monitor all forms of harmful tax competition and to enforce counter-measures effectively imposes significant administrative costs on countries adversely affected by such competition. Fourth, uncoordinated unilateral measures may increase compliance costs on taxpayers.[13]

Residence countries can partly negate the effects of harmful preferential tax regimes in source countries, but even here such action is likely to be most effective if undertaken in a co-ordinated way. It should be emphasised, however, that the ability of one country to take defensive measures cannot justify the enactment of harmful preferential tax regimes in another country, since it is difficult to fully nullify the harmful effect by such defensive measures, and that even if it were possible, the residence country would have to bear the implementation and administration costs associated with such defensive measures.[14]

Since unilateral measures are easiest for countries to adopt, as they do not require acquiescence of other countries, the Report begins by recommending action in this area and then elaborates on bilateral approaches, which occur through tax treaties. The Report then discusses multilateral responses to curbing harmful tax practices. These responses are the most difficult to adopt because

[13] The Organisation for Economic Cooperation and Development (OECD) Global Forum on Taxation met in Melbourne, Australia on 15 to 16 November 2005 (2005 OECD Melbourne Meeting) to consider level-playing-field issues related to the OECD's proposals against harmful tax practices (OECD Proposals). The OECD Proposals were initially in the OECD's seminal 1998 report, Harmful Tax Competition: An Emerging Global Issue (1998 OECD Report), followed by other OECD documents. Luxembourg and Switzerland abstained from the 1998 OECD Report (Annex II thereof). As discussed below, several developments since the 1998 OECD Report might shape implementation of the OECD Proposals. After the 2005 OECD Melbourne Meeting, the OECD issued a statement, Progress Towards a Level Playing Field: Outcomes of the OECD Global Forum on Taxation (2005 OECD Melbourne Report), describing the purpose of the meeting-- to review implementation of the process for working towards a global level playing field based on high standards of transparency and effective exchange of information in tax matters that the Global Tax Forum agreed to in Berlin in June 2004.. See David E Spencer, Jason C Sharman, OECD PROPOSALS ON HARMFUL TAX PRACTICES: A STATUS REPORT, 13 NZJTLP 129

[14] Id.

countries must co-operate with each other in developing and implementing a response.[15] Nevertheless, these multilateral responses are essential because, as this Report has explained, co-ordinated action is the most effective way to respond to the pressures created in the new world of global capital mobility. Even though the unilateral and bilateral responses require minimum co-ordination with other countries, it has also been stressed that measures to fight harmful tax practices will be more effective if they conform to practices adopted at the international level.

The need for co-ordinated action at the international level is also apparent from the fact that the activities which are the main focus of this report are highly mobile. In this context, and in the absence of international cooperation, there is little incentive for a country which provides a harmful preferential tax regime to eliminate it since this could merely lead the activity to move to another country which continues to offer a preferential treatment.[16]

Since unilateral measures are easiest for countries to adopt, as they do not require acquiescence of other countries, it has been recommended by the OECD that action in this area and then elaborates on bilateral approaches, which occur through tax treaties. Multilateral responses to curb such practices must be taken up countries. These responses are the most difficult to adopt because countries must co-operate with each other in developing and implementing a response. Nevertheless, these multilateral responses are essential because, co-ordinated action is the most effective way to respond to the pressures created in the new world of global capital mobility. Even though the unilateral and bilateral responses require minimum co-ordination with other countries, this Report has also stressed that these measures will be more effective if they conform to practices adopted at the international level.

Since its inception in 1961, the OECD has served as a forum and advisor to improve the economies of its member countries, increase global market efficiency, and to facilitate expansion of trade between both industrialized and developing nations.[17] In pursuit of these goals, it has sought to

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[15] Richard M. Bird and Pierre -Pascal Gendron, TAXATION IN FEDERAL STATES: INTERNATIONAL EXPERIENCE AND EMERGING POSSIBILITIES, available at, http://isp-aysps.gsu.edu/papers/ispwp0104.pdf

[16] It is clear, however, that tax havens reduce incentives to conduct business in high-tax countries, and recent evidence suggests that the presence of nearby tax havens stimulates activity in high-tax locations.

[17] The OECD was established in 1960 for the stated intentions of: 1) achieving sustainable economic growth in member countries, while contributing to the financial stability of the world economy, 2) continually expanding the economies of member countries and to develop those of non-member countries, and 3) contributing to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations. Currently, its membership consists of Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. http://www.oecd.org/dataoecd.html

promote internationally favourable legislation among member and non-member nations so as to reach a unified global economic system. One of its most recent pursuits began in 1996, when the OECD was prompted by the notable decrease in domestic tax revenues among its member nations to address the rising issue of harmful tax competition.[18] Since then, the OECD has produced various guidelines and aggressive strategies intended to identify and initiate a unified, multilateral offensive against nations engaging in harmful tax practices.

In 1998, the OECD began its campaign by issuing a report listing those competitive tax practices it deemed strong indicators of harmful tax competition. Doing so created a standard that allowed the OECD to later reveal those nations considered to be tax havens. Specifically, the 1998 report held that by imposing no or low effective tax rates, maintaining laws that hinder or prohibit the effective exchange of financial information with other jurisdictions, not requiring investors to engage in substantial investment or transactional activities, and not demonstrating legislative, administrative, or legal transparency concerning issues of foreign investment, a nation would be considered a harmfully competitive tax haven. The 1998 report also promulgated a list of policy recommendations to assist offending nations in reforming their practices along with a list of defensive measures that countries could take to protect themselves from the effects of harmful tax competition. Lastly, the OECD avowed to produce a list of regimes they believed to be tax havens according to the factors provided in the report, unless those nations agreed to comply with the 1998 report's guidelines in advance.[19]

The OECD produced that list in its 2000 report entitled Toward Global Tax Co-operation, and it identified thirty-five jurisdictions, the vast majority of which were small island nations, as tax havens. The OECD's purpose in producing the list was to stigmatize those nations practicing harmful tax competition in an attempt to discourage investors from engaging in further transactions in these now notorious financial centres.[20]Any country listed as a tax haven would have to commit to either

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[18] The OECD specifically states that "governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce the tax that would otherwise be payable to them."

[19] OECD Report on, Harmful Tax Competition: An Emerging Global Issue, 1998

[20] Bank secrecy (or bank privacy) is a legal principle under which banks are allowed to protect personal information about their customers, through the use of numbered bank accounts or otherwise. Effective bank secrecy is better achieved in certain countries, such as Switzerland or in tax havens, where offshore banks adhere to voluntary or statutory levels of privacy. Created by the *Swiss Banking Act* of 1934, which led to the famous Swiss bank, the principle of bank secrecy is sometimes considered one of the main aspects of private banking. It has also been accused by NGOs and governments of being one of the main instruments of underground economy and organized crime, in particular following the Class action suit against the Vatican Bank in the 1990s, the Clearstream scandal and September 11, 2001 at http://en.wikipedia.org/wiki/Bank_secrecy

implement the OECD's 1998 recommendations or create an acceptable plan to revise their tax laws to be executed by the end of 2005. In addition, the 2000 report provided a list of sanctions and defensive policy measures that it encouraged all countries affected by harmful tax competition to use in order to minimize the detrimental effects caused by offending tax haven nations. All affected nations were to adopt the OECD's recommended measures in order to pressure tax havens into allowing the free exchange of financial information with foreign tax authorities seeking to subject their residents to domestic taxes. Furthermore, it is argued that the OECD intended the defences and sanctions as a means to coerce tax haven nations to raise their effective tax rates to harmonize with the much higher ones of the OECD member nations.[21]

The OECD's affirmative actions taken to combat harmful tax competition have left offshore tax havens in a serious dilemma. Either they can comply with the recommendations and relinquish the competitive advantages of their financial industries or they can choose to remain uncooperative and face multilateral sanctions. Regardless of their decision, they are certain to face serious risks of economic backlash.[22]

It is clear from its 2000 list that OECD efforts to minimize harmful tax competition have focused on small offshore tax haven nations. Yet it is the fact that many of these haven nations generally maintain vulnerable and developing economies that raises questions as to the appropriateness of the OECD's campaign. The reality is that many of these tax haven nations were former European colonies with unstable economies that were rooted in agriculture or other basic industries.[23]

Unfortunately, not much has changed with the passage of time as these islands continue to rely heavily upon single-crop agricultural trade and tourism for fiscal preservation. As a result, these nations have generally been unable to catalyze strong, self-sufficient economies due to the high costs of distant trading, volatility of regional climate, a changing global trade market, and frequent complications due to political corruption that significantly affect the agriculture and tourism industries. Consequently, these island havens have continued to experience poverty, high levels of national debt, and stagnant fiscal growth, which has restrained them from becoming financially independent and competitive in the high-tech global economy.[24]

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[21] Kimberly Carlson, *When Cows Have Wings: An Analysis of the OECD's Tax Haven Work as It Relates to Globalization, Sovereignty and Privacy*, 35 J. Marshall L. Rev. 163, 178 (2002)
[22] *Id.*
[23] Tolley'*s International Tax Planning,* (2002), at para 26.1
[24] http:// www.imf.org/external/np/speeches/2004/061104a.htm

These nations innovative establishment of competitive offshore financial centres, however, has alleviated many of these financial ills and moved them toward financial independence. Following the implementation of strict financial secrecy laws and levying low or no taxes on foreign investors, more than $200 billion dollars of foreign direct investment had entered the Caribbean and South Pacific tax haven nations by 1994, a figure ten times greater than that reported in 1985. Other reports suggest that the amount of foreign capital held in these island nations is actually around $8 trillion. More recent statistics indicate that the Cayman Islands alone hold over $670 billion in banking assets from investors around the globe.[25]

Because of the vast sums of capital entering their shores, the economies of these tax haven nations have become dependent upon the competitiveness of their financial centres to sustain wealth within the private sector, create work opportunities essential to decrease national unemployment rates, and provide sufficient government revenues to finance public health and education expenditures. For example, the financial centres in the small island of Vanuatu provide between $3 million and $4 million to the nation's government and 10% of its Gross Domestic Product (GDP), while also creating four hundred jobs in the nation's banking industry. Similarly, it is estimated that 8% to 10% of the GDP of the offshore tax havens in the Pacific are derived from their competitive financial centers, while the Caribbean island of Nevis alone derives more than 30% of its tax revenues from its offshore financial industry. In addition, from 1992 to 1997, the money generated in the Bahamas due to its activities as a tax haven accounted for 15% of its national income and 20% of its government revenues; while financial centres in Barbados reaped 5% of national income and 22% of government proceeds. Public dependence is so elevated that, currently, the government of Barbados derives as much as one third of its revenue through its competitive financial institutions. It is even reported that 80% of the Isle of Jersey's income is generated through its financial services industry.[26]

Given this significant fiscal dependence, any loss of competitiveness in the financial services sector resulting from the OECD's actions would have catastrophic results. It is reported that these developing nations could realize as much as a 25% decrease in GDP should they alter their current tax practices to adhere to OECD guidelines. Such striking losses would lead to an economic collapse devastating enough to return these offshore tax havens to their total dependence on highly unstable industries. Consequently, all recent attempts to achieve the economic development, stability, and independence sufficient to control poverty and other social ailments experienced by

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[25] *Id.*

[26] Akiko Hishikawa, *The Death Of Tax Havens*?, 25 B.C. Int'l & Comp. L. Rev. 389

these nations would be throttled.[27]

Unfortunately, since the advent of the OECD's report on harmful tax competition in 1998, these developing nations have already begun to experience devastating losses to their financial sectors. For example, by adopting legislation to comply with OECD guidelines, Antigua and Barbuda lost fifty-four of the nation's seventy-two banks while the number of businesses incorporated in the territory dropped from 12,378 to 10,797. Such losses resulted in a notable decrease in the employment rate and GDP on the island nation. It is also reported that the nation of St. Vincent and the Grenadines experienced an unemployment rate of 25% to 40% due to the closure of various banks and insurance companies on its islands. Similarly, the pressure from the OECD has forced the Commonwealth of Dominica to shut down one of its banks, while several other banks have fled the island on their own volition to sever association with the nation blacklisted as engaging in harmful tax competition. Because of the lost revenue, Dominica was forced to alter its national budget to include increased domestic taxes on fuel, sales, cable, and telecommunications services as well as cuts in the size of its government's cabinet.[28]

Even nations that avoided being named on the OECD's 2000 report by granting an advanced commitment to comply with OECD recommendations have experienced similar economic droughts because they have agreed to open financial information exchange and alter taxation policies. For example, since acquiescing to OECD demands, the Cayman Islands have closed several banks, threatened to revoke the charters of companies incorporated within their jurisdiction that had not demonstrated significant domestic transactional activities, and forced its financial services industry not to guarantee absolute financial secrecy to clients. By initiating similar reforms in adherence to the OECD's principles, many offshore havens stand to harm their domestic economies, which have relied on the competitive advantages of their offshore financial industries for economic survival.

Though the above observations demonstrate the seriously detrimental effects the OECD's tactics have had on offshore tax havens' already vulnerable economies, these effects could worsen as the OECD continues to apply pressure on these nations to conform to its tax policy recommendations.[29] The irony, however, is that the elimination of the competitiveness of offshore financial centres and consequent detriment to these developing island nations is not likely to result in the OECD's elimination of harmful tax competition.

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[27] *Id.*

[28] Supra Note 23

[29] Wolfgang Schön, Tax Competition in Europe--General Report, ed., 2003 It has been noted how high-tax OECD countries have taken steps, such as lowering taxes, to compete in the European tax setting.

While the OECD's actions work to dismantle offshore tax haven economies, they are unlikely to discontinue harmful tax competition in the future for two major reasons. First, tax policies and preferences among the OECD member countries have proven to be so widely divergent that harmful tax competition does and will continue to exist between the member nations even if the OECD's efforts to eliminate the effects of offshore tax havens succeed. Second, key members have refused their support for the OECD's efforts, which has severely diluted the possibility of maintaining the forceful multilateral campaign needed to deter harmful tax practices. Because of these abstentions and the overall lack of common ground on the issue, the OECD's aggressive efforts will prove ineffective in countering harmful tax competition in the future.[30]

Despite the OECD's call for a unified front against harmful tax competition, not all of its member countries are in accord with the campaign, while others continue to engage in tax practices that have the potential to dislocate foreign tax bases. This variance of interest in the attack against harmful tax competition is manifested in the OECD's 2000 report, which acknowledged that a significant number of its member countries continued to harbour "preferential tax regimes" that continue to harbour potentially harmful tax regimes. In fact, though the OECD was internally prompted to combat the ills of harmful tax competition, it reported that twenty-one out of thirty members still maintained financial sectors engaged in potentially harmful tax practices.[31]

Another demonstration of conflicting interests within the OECD concerning tax policy is the wide range of corporate tax rates imposed by its members. Though the average rate of corporate taxation among OECD nations was 31.39%, several member countries have drastically undercut this level with markedly lower rates. For example, Ireland recently imposed an effective tax rate of just 7.6% on foreign-sourced investments from U.S. multinational corporations. Although outside pressures compelled Ireland to raise its overall effective corporate tax rate to 16% in 2002, it emplaced the competitively low rate of 12.5% by 2003.[32] By boasting a below average corporate tax rate of 18%,

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[30] Supra Note 23

[31] The nations mentioned include: Australia, Belgium, Canada, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Korea, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and the United States. A "preferential tax regime" differs from a tax haven according to the OECD's guidelines in that it is a country that collects significant revenues from its domestic income tax, but whose tax system has features constituting harmful tax competition. Furthermore, preferential tax regimes include financial industries such as banking, insurance, or mutual funds that may utilize competitive features, but not features, such as strict financial secrecy, that the OECD focused on in its 1998 report. Thus, there is not yet a determination as to whether the tax practices are actually harmful. See Supra Note 23

[32] Robert T. Kudrle & Lorraine Eden, The *Campaign Against Tax Havens: Will It Last? Will It Work?*, 9 Stan. J.L. Bus. & Fin. 37, 51 (2003) (explaining how the fiscal decentralization of the EU allowed for effective campaigns to address Ireland's discriminatory corporate tax rate and Belgium's attempts to attract foreign corporate headquarters)

Hungary also provides unfairly advantageous alternatives to international investors. Yet another OECD country participating in tax competition is the United States, a nation which some consider the world's largest tax haven. In particular, current U.S. tax laws allow multinational corporations to decrease or even eliminate taxes the United States may impose on them.[33] Also, incorporation laws in some U.S. states provide corporate tax advantages similar to the offshore tax havens that the OECD has blacklisted.[34]

Like the offshore tax havens, these low-tax member countries threaten the tax bases of the high taxing welfare states that steered the OECD's efforts against harmful tax competition. As a result, many prominent welfare state regimes have taken both defensive and offensive measures to minimize the effects of tax competition within the OECD itself. For example, Denmark was forced to lower its corporate tax rates to 30% to compete against its European, OECD peers in generating optimal domestic tax revenue. Similarly, the Netherlands has argued that the low corporate tax rates found in some OECD member nations pose a threat to its domestic tax base. Accordingly, it has demanded that the OECD set a minimum corporate tax rate for member countries to adopt in order to preserve a fixed level of tax revenue.

Yet another area that evidences a lack of cohesion of interests among OECD nations relates to banking secrecy laws, which vary in their degree of rigidity of banking privacy afforded clients. For instance, Switzerland has been long recognized as providing some of the strictest financial secrecy laws in the world.[35] This is explained by the fact that a breach of financial secrecy is deemed an elevated breach of trust under Swiss law, for which a violator is subject to criminal prosecution. Furthermore, there is no exception to this rule when information is requested by foreign or domestic tax authorities, even in cases of tax evasion. A similarly strict banking law is found in Luxembourg, where even domestic tax authorities are not permitted to seek information from banks concerning their clients' finances unless very limited exceptions apply. Even the United States does not require its banks and other financial institutions to freely exchange financial information of

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[33] Delaware offers corporations numerous advantages including inexpensive same-day company incorporation, low fees, minimal financial filing requirements, protection from hostile takeovers, freedom to operate companies anonymously, no required public disclosure of accounts, shareholder secrecy, no sales or inheritance tax, tax advantages for holding companies, and a court system that is seen as having unequalled expertise in complex cases involving multinational companies. http://www.en.wikipedia.com

[34] Steven A. Dean Philosopher Kings And International Tax: A New Approach To Tax Havens, Tax Flight, And International Tax Cooperation, 58 Hastings L.J. 911

[35] See generally International Bank Secrecy (Dennis Campbell ed., 1992) (illustrating the variance of client protection throughout the world by reviewing international banking secrecy laws).

clients with foreign tax agencies.[36]

These stringent prohibitions against information exchange are in stark contrast to the policies of other members of the OECD, which require banks to openly share their clients' financial data with tax authorities. For example, Italian laws have allowed tax agencies to circumvent banking secrecy at will when conducting tax audits.[37] Furthermore, Swedish law requires banks within its jurisdiction to send information annually to tax authorities regarding interest paid to resident clients. Few countries are more cooperative with tax agencies than Sweden, however, whose laws have granted tax authorities such open permission to obtain client information from banks that many question whether any protection of information from tax authorities exists at all. Based on these differences in tax practices among the OECD members, it is clear that harmful tax competition continues to thrive and will continue to do so even if the effects of offshore tax havens are neutralized.[38] Varying interests in tax policy have not only fostered tax competition within the OECD, but they have also caused several key members to abstain from or withdraw their support for measures to combat harmful tax competition.[39] When the OECD's 1998 report was released, both Switzerland and Luxembourg refused to sign the agreement because of their discord with the organization's harsh stance against banking secrecy.

Their disapproval of the OECD's aggressive actions has not faltered, as they have continued to withhold their endorsement of the OECD's subsequent reports. Given the historically strict banking secrecy laws in these two countries, their non-compliance seriously undermined the OECD's efforts to have its members agree to adopt legislation to open the exchange of financial information with foreign tax agencies. Yet Switzerland and Luxembourg were not alone, as several other member countries withdrew their support from the OECD's campaign as later reports and recommendations were produced. For example, both Belgium and Portugal rescinded their approval of the OECD's efforts against harmful tax competition following its release of a 2001 update of its goals and progress. Though Belgium and Portugal agreed with some aspects of the OECD's plan, the impetus for their withdrawal was their objection to the more onerous demands made upon some member

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[36] Violations of Swiss banking secrecy laws are on par with breaches of silence in official matters such that violators are prosecuted at the initiative of the court, whereas violators of professional secrecy, such as doctors and lawyers, are prosecuted only at the initiative of the injured party. *Id.*

[37] Reuven S. Avi-Yonah , *A PROPOSAL TO ADOPT FORMULARY APPORTIONMENT FOR CORPORATE INCOME TAXATION: THE HAMILTON PROJECT* , University of Michigan Law School, Reed College, April

[38] Supra Note 23

[39] Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar And The Tax Shelter Industry*, Yale Journal on Regulation, Winter 2006, 23 Yale J. on Reg. 77

nations to implement changes in tax legislation.[40]

Probably the most devastating blow to the OECD's campaign, however, was the defection of the United States in 2001. Citing its disinterest in global tax harmonization, efforts to coerce foreign nations to adopt specific tax policy, and aggressive policies against tax evasion, the United States decided that the OECD's report was overly broad and inconsistent with the country's tax and economic priorities.[41] Given the country's clout as a global economic leader, many member nations felt that inclusion of the United States in the OECD's efforts was essential to the OECD's success, and thus the organization was forced to amend its project to ensure U.S. involvement. Those revisions diluted the overall aggressiveness of the campaign by relaxing measures against tax evasion, lifting sanctions on tax havens practicing ring fencing, and extending the deadlines by which countries had to commit to cooperate with the OECD's initiatives.[42]

This lack of support by key member nations has had two major repercussions on the OECD's efforts against harmful tax competition. First, such defections have weakened the multilateral leverage of the OECD's efforts, which even the organization itself has admitted is crucial to the overall effectiveness of the project. Second, non-compliance by member countries has given offshore tax havens a strong argument in their opposition of the OECD and its recommendations. Essentially, they have noted the injustice of forcing economically vulnerable island nations to conform to the OECD's recommendations when its own members have refused to do so. Given these serious threats to a unified and widely-supported effort against harmful tax competition, the future effectiveness of the OECD's project is in doubt.[43]

Because its efforts have focused on coercing offshore tax havens to open financial disclosures and engage in less competitive tax practices, the OECD's campaign against harmful tax competition has gravely endangered the fiscal stability of emerging tax haven economies. Doing so without unified cooperation or concerted tax policy interests among its own members seriously calls into question

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40 Belgium and Portugal had already recognized the practice of ring fencing within their borders and had committed to its elimination. Id. Ring fencing was identified by the OECD as the practice of by a financial centre or regime of partially or fully isolating itself from its domestic economy by either excluding resident taxpayers from taking advantages of its tax benefits or by harbouring enterprises that prohibit operation in the domestic market.

41 In subsequent talks with the OECD, the United States also manifested its opposition to the harsh OECD stance against tax evasion. See William Brittain-Catlin, Offshore: The Dark Side Of The Global Economy (2005). Cited at FN. 2 of Richard A. Johnson, *Why Harmful Tax Practices Will Continue After Developing Nations Pay: A Critique Of The OECD's Initiatives Against Harmful Tax Competition,* Boston College Third World Law Journal Spring, 2006, 26 B.C. Third World L.J. 351

42 *Id*

43 *Id*. Explaining U.S. concerns that Osama Bin Laden and other terrorist supporters have contributed to Al Qaeda funds secretly held offshore

the appropriateness of the OECD's campaign against harmful tax competition.

CHAPTER 4: MONEY LAUNDERING

Money laundering is the method of concealing the proceeds of criminal activity in order to disguise its illegal origin and create the appearance that it was generated through legitimate business activities so that the perpetrators can spend their booty with the minimum of suspicion. Governments have designated it a criminal offence in its own right, just like the underlying offence(s) which result in the proceeds being obtained in the first place, in an attempt to take the profit out of crime. Different jurisdictions have historically defined crime predicating the offence of money laundering in different ways and it normally included only those crimes that were universally considered to be 'serious', such as narcotics trafficking, weapons dealing, racketeering and murder. For example, offshore financial centres would refuse all requests for judicial assistance from foreign governments if those requests in any way involved an investigation into tax evasion, which was not recognized as an offense in offshore centers and, therefore, did not meet the legal standard of dual criminality, i.e. it must be an offense in both countries for judicial co-operation to kick in. Offshore tax havens have long been associated with money laundering because their strict financial secrecy laws allow the creation of anonymous accounts while prohibiting the disclosure of financial information to foreign tax authorities. Recent reports indicate that as much as $600 billion of illegal money is hidden in offshore banks. Furthermore, there is strong evidence indicating that a substantial portion of these funds concealed offshore has been used to sustain terrorist groups such as Al-Qaeda. Consequently, many countries and international groups have implemented measures to curb the prevalence of international money laundering, though most efforts have proven ineffective.[44] Nevertheless, there is an indication that a new wide-scale, multilateral effort against money laundering would prove successful, ironically because the barriers that the OECD's campaign against harmful tax competition faces are not present on this particular issue. Specifically, anti-money laundering policies

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[44] Following the 9/11 attacks, the United States enacted the USA PATRIOT Act, which included the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (IMLAAFA). The IMLAAFA granted the Secretary of the Treasury the authority to require domestic financial institutions to implement increased record-keeping and reporting procedures or face economic sanctions. A prominent multilateral measure against money laundering was initiated by the Financial Action Task Force (FATF), which produced a list of policy recommendations for members and non-members to combat money laundering. Also, the FATF produced a list in 2000 meant to blacklist those nations "whose detrimental practices seriously and unjustifiably hamper the fight against money laundering." Unfortunately, many initiatives enacted to minimize global money laundering have been unsuccessful, especially those enacted before 2001. The reason for this general ineffectiveness is the "lack of uniformity and cooperation in anti-money laundering legislation across nations."

are less invasive to financial secrecy, thus posing only a nominal economic threat to the fragile offshore tax haven economies. In addition, due to the uniform nature of money laundering and recent high-profile terrorist attacks, the current global climate indicates a tremendous convergence of global interests on the matter.

Money laundering is truly a global issue because, unlike harmful tax competition, it affects the financial institutions of every country. Even the world's most developed countries, including the United Kingdom and the United States, have contributed to the problem.[45] Furthermore, because money laundering is a criminal matter rather than one of tax policy preference, there has been universal recognition of its impropriety as well as accord in the urgency to address it through unified policy. However, it is because of major recent terrorist attacks that international interest have converged to such a point as to ensure the needed cooperation for an effective multilateral campaign against money laundering.

Following the 9/11 terrorist attacks, the United States immediately enacted laws to aid in uncovering terrorist funds held in its financial centres.[46] Soon after, numerous developed nations and offshore tax havens were prompted by U.S. initiatives and quickly agreed to adopt measures to combat international money laundering and uncover hidden terrorist financing. Since then, fervour for the search of terrorist funds through anti-money laundering legislation has only intensified, especially following the London bombings on July 21, 2005. What is important, however, is that this zeal is not centralized within a few nations of similar culture or disposition; rather numerous countries of varied background have recently experience the first-hand effects of terrorism including Jordan, Spain, the Philippines, and India. Because this internationally convergent interest indicates the elevated potential for effectiveness, now is the opportune time to initiate a unified, multilateral campaign against money laundering.

Offshore financial centers been left with 'Hobson's Choice': implement FATF's recommendations and lose significant business because foreign clients will go somewhere else or do not implement the recommendations and lose business anyway because your name will go on a global black-list and other types of foreign clients will be pressured into no longer doing business with you. Even those

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[45] After the fall of the Russian economy in the 1990s, it was discovered that the Bank of New York was used to launder an estimated $7.5 billion of illegal money from Russia.

[46] The USA PATRIOT Act was passed just weeks after the 9/11 attacks. This Act contained the IMLAAFA, which gave the government special power to require stricter financial record keeping by domestic banks with aggressive sanctions for non-compliance.

that do want to be a good global citizen are faced with the problem of how to pay for the introduction of these new measures.

Some small and emerging countries have felt bullied by the world's major countries and there is a lingering suspicion that FATF's measures, in conjunction with a global "tax harmonization" drive by the Organisation for Economic Co-operation and Development, are as much designed to help major countries collect more taxes as they are to stamp out major crime that is not tax-related. Developing or transition countries are particularly vulnerable to money laundering because they generally lack the level of legal, enforcement and professional sophistication required to effectively regulate one of the most complex areas of criminal activity.

Many also lack the finances to implement a system that will meet international standards. However, if they do not meet these standards, they are likely to find themselves on FATF's list of 'Non Cooperative Countries and Territories' which, apart from being embarrassing, may lead to a loss of revenue as companies in countries that do meet these standards shy away from doing business with them for fear of attracting the unwelcome attention of their home regulators and law enforcement agencies.

Another negative consequence of failing to control money laundering is that it encourages some of the world's worst criminals, such as terrorists and narcotics traffickers, to establish a foot-hold in a country, with all of the underlying problems that brings, such as threats of violence, bribery, corruption, murder, etc.

Money Laundering: The Indian Scenario

With increasing sophistication in the use of technology for transfer of funds and given the fact that there has been considerable liberalization and progressive dismantling of controls in the regulatory framework in India, banks in India need to be in a state of high alert so that they can steer clear of Money Laundering. It is important to remember that banks and financial institutions are both transmitters of money and regulators of the flow of money.[47]

In India, certain prudent banking practices which check the proliferation of Money Laundering activities in the country are there. Some of these practices are outlined below:

[47] S.Ganesh , Money Laundering, See http://www.rbi.org.in

- Identification of prospective clients is carried out prior to the opening of a bank account by obtaining proper introduction. This procedure partly addresses the requirement of KYC.[48]
- Criminal investigation is allowed in banking transactions in India. For example, the Income Tax Department can call for information relating to customers accounts and transactions. Erring accounts can be frozen. This addresses the Basle Principle on Compliance with legislation and law enforcement agencies.
- Certain statues such as "The Bankers Books Evidence Act, 1891" and the "Banking Companies (Preservation of Records) Rules, 1985" require the making available / retention of records to investigating agencies, which addresses the Basle Principle on Record Keeping and Systems.

Existing Legal Framework to Curb Money Laundering in India

The Prevention of Money Laundering Act, 2002 (PMLA 2002) forms the core of the legal framework put in place by India to combat money laundering. PMLA 2002 and the Rules notified there under came into force with effect from July 1, 2005. The PMLA 2002 and rules notified there under impose obligation on banking companies, financial institutions and intermediaries to verify identity of clients, maintain records and furnish information to financial intelligence unit, India. PMLA 2002 defines money laundering offence and provides for the freezing, seizure and confiscation of the proceeds of crime.[49] In addition to the PMLA certain other legislations also aim towards curbing money laundering. They are as follows:[50]

- The Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974
- The Income Tax Act, 1961
- The Benami Transactions (Prohibition) Act, 1988
- The Indian Penal Code and Code of Criminal Procedure, 1973

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[48] In order to comply with regulatory provisions under the Prevention of Money Laundering Act 2002, Rules issued thereunder and related guidelines/circulars issued by SEBI, KYC formalities are required to be completed for all Unit Holders, including Guardians and Power of Attorney holders, for any investment (whether new or additional purchase) of Rs. 50,000 or more in mutual funds. For the convenience of investors in mutual funds, all mutual funds have made special arrangements with CDSL Ventures Ltd. (CVL), a wholly owned subsidiary of Central Depository Services (India) Ltd. (CDSL)). See http://www.amfiindia.com/showhtml.asp?page=kyc

[49] http://fiuindia.gov.in/pmla2002.htm

[50] Supra 47

- The Narcotic Drugs and Psychotropic Substances Act, 1985
- The Prevention of Illicit Traffic in Narcotic Drugs and Psychotropic Substances Act, 1988

CHAPTER 5: EFFECTS OF TAX HAVEN ON INDIA

The Indo-Mauritius DTAA was first signed in 1983. The main provision was that no resident of Mauritius would be taxed in India on capital gains arising out of sale of securities in India. The treaty gives capital gains exemption for investments if routed via Mauritius. It's been a very controversial treaty. During the last six years it has been in the news particularly because of public interest litigation in Supreme Court of India challenging some of its provisions.[51] To prevent its misuse officials want the Treaty to have the same provisions as incorporated in the treaty with Singapore. The India-Singapore Double Tax Avoidance Treaty has got virtually similar provisions, but tax exemption is only for bona fide businesses.[52]

Mauritius has since abolished capital gains tax so that effectively there are no taxes on Mauritius-based foreign institutional investors (FIIs) investing in India. In the last few years Mauritius has emerged as the largest foreign investor in India thus clearly indicating that it has become a tax haven for foreign investors. This indicates the route investors are taking into India to avoid otherwise due taxation. Inspite of the controversies generated, various Indian Finance Ministers have strongly supported it in its present form. They maintained that changing its clauses would lead to flight of capital from the country, slowing down foreign investment inflows and may lead to a significant stock market crash. But, in an unexplained turn around, the Indian Finance Ministry has now admitted in the Indian Parliament that DTAA is being misused. It has thus decided to review some of its provisions particularly those that are leading to what's called 'treaty shopping'.

Before dealing with this in greater detail, it's important to explain the principles and the philosophy behind double taxation agreements and the ways in which some of them are abused across the world. Nations normally sign such treaties so that corporate entities and individuals, with businesses in several countries, do not have to pay taxes on the same income twice i.e. in the country of their

[51] http://www.indlawnews.com/1300b460f01af76ca5ae693532b82d65
[52] http://www.cainindia.org/news/7_2006/indomauritius_tax_treaty_under_cloud_.html

origin and in the one they are operating in. The problem arises when provisions of such bilateral agreements aren't interpreted properly by tax authorities and, more specifically, when such treaties are signed with offshore finance centres or what are commonly known as tax havens. Since tax havens like Mauritius do not levy any meaningful income tax on domestic offshore firms others have very low rates it opens up opportunities for corporate entities to avoid paying any taxes or paying just nominal taxes.[53]

India allows the Mauritius-based firms to pay taxes on their India income as per Mauritius laws. Thus, the Mauritius entities end up paying nearly zero tax on income from Indian operations. Because of Mauritius laws, where entities can be residents merely by registering their firms locally, the potential for abuse is immense. It is reported that Indians used Mauritius-registered companies and Mauritius offshore trusts to hold assets abroad beyond the reach of Indian tax laws. This is called 'round-tripping', where Indians re-route their money stashed abroad through the Mauritius route. In a May 2005 report to Parliament, the Comptroller and Auditor General of India (CAG) proposed that the income of FIIs from stock market activities should be treated as business profit and taxed accordingly. Unfortunately this proposal was ignored by the Parliament.[54]

The DTAA signed with Mauritius in 1983 specified that capital gains made on the sale of shares of Indian companies by investors resident in Mauritius would be taxed only in Mauritius and not in India. For 10 years the treaty existed only on paper since FIIs were not allowed to invest in Indian stock markets. That changed in 1992 when FIIs were allowed into India. The same year, Mauritius passed the Offshore Business Activities Act, which allowed foreign companies to register in the island nation for investing abroad. Registering a company in Mauritius has obvious advantages such as, total exemption from capital gains tax, quick incorporation, total business secrecy and a completely convertible currency.

Round Tripping

Thus, the Mauritius entities end up paying nearly zero tax on income from Indian operations. Because of Mauritius Laws,[55] where entities can be residents merely by registering their firms locally,

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[53]http://timesofindia.indiatimes.com/NEWS/India_Business/India_to_push_for_change_in_tax_treaty_with_Mauritius/articleshow/1068539.cms

[54] Report No.13 of 2005 (Direct Taxes) See. http://cag.nic.in/reports/d_taxes/2005_system/Chapter3.pdf

[55] The Mauritian Offshore Business Activities Act, 1992 specifies minimum requirements for setting up of an offshore business entity.

the potential for abuse is immense. It is reported that Indians used Mauritius-registered companies and Mauritius offshore trusts to hold assets abroad beyond the reach of Indian tax laws.[56] This is called 'round-tripping', where Indians re-route their money stashed abroad through the Mauritius route.

Treaty Shopping

Treaty Shopping is a condition where a national or resident of a third country seeks to obtain the benefit of a DTAA between two other countries by interposing a company or other entity in one or the other of them.[57] This means that foreign investors in third countries with relatively high rates of taxation on income/profits earned by companies and/or capital gains accruing from transactions in shares and securities are using the Mauritius route to bring investments to India by taking advantage of the DTAA[58]. In the last few years Mauritius has emerged as the largest foreign investor in India thus clearly indicating that it has become a Tax Haven for foreign investors. This indicates the route investors are taking into India to avoid otherwise due taxation.[59]

Political Angle

Inspite of the controversies generated, various Indian Finance Ministers have strongly supported it in its present form. They maintained that amending the treaty would lead to flight of capital from the country, slowing down foreign investment inflows and may lead to a significant stock market crash.[60] But, in an unexplained turn around, the Indian Finance Ministry has now admitted in the Indian Parliament that DTAA is being misused

Thus, recently the Indian government have been pressurising the Mauritius government to make amendments in the DTAA[61], to overcome the abusive usage such as double tripping and *Treaty Shopping*, in an attempt to increase tax collection from many corporate transactions, engineered by non-Mauritius residents out of that island country

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56 See Report of Comptoller and Auditor General of India (CAG): 'Union Audit Report on Direct Taxes (2003-2004)- Report No 13 of 2005

57 *Supra* 1

58 Since Mauritius abolished capital gains tax, as mentioned above, effectively there are no taxes on Mauritius-based FIIs investing in India.

59 The *Azadi Bachao Andolan* case has validated *Treaty Shopping* on the ground of being a policy decision to be taken by the central government and has gone for a very restrictive interpretation of the DTAA.

60 The report of the Joint Parliamentary Committee on Stock Market Scam
See http://www.rbidocs.rbi.org.in/rdocs/notification/PDFs/33840.pdf

61 Shantanu Nandan Sharma, *CBDT Chairman In Mauritius To Plug Tax Avoidance Loopholes,* ECONOMIC TIMES, February 10, 2008 (Edn.)

Judicial Response to Indo-Mauritius DTAA

For the first time the Indo-Mauritius DTAA was judicially examined in the ***Advance Ruling No. 9 of 1995.***[62] Two entities incorporated in Mauritius sought an Advance Ruling with respect to their dividend income paid by and Indian Company being subjected to withholding tax in India. Article 10 Paragraphs (1) and (2)[63] of the DTAA provided that dividend income shall be taxable in the Country in which the entity paying the dividend is a resident of. The rate of tax on the dividend income was fixed at 5% in cases where the beneficial owner is a company which holds directly at least 10% of the capital of the company paying the dividends and 15% in all other cases. Each of the two companies, carried on the business of investing in the banking and financial sector in India and had invested over US $ 60, 00,000 by way of subscription for shares in an Indian Bank.

The applicant sought confirmation that the dividends it receives from the Indian bank will be subject to withholding tax which shall not exceed 5% of the gross amount of the dividends and that any gains derived by the applicant from the eventual alienation of its shares in the said bank will not be taxable in India. It was also stated that the applicant was a fully owned subsidiary of a banking company of Britain which was certified by the Company Secretary.

The Authority dealt with the residence status of the Company with respect to the question that since the entire shareholding of the company was with the Bank situated in Britain whether the effective management of the Company is situated in Britain or Mauritius? It was held that "place of effective management" refers to the place from where, factually and effectively, the day to day affairs of the companies are carried on and not to the place where the ultimate control of the company resided and therefore deciding that the company was resident of Mauritius. [64] As regards the withholding of tax was concerned; Article 10 of the DTAA[65] provides for the taxation of dividend income.

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[62] [1995] 220 ITR 377 (AAR)

[63] ARTICLE 10 - *Dividends* - *1.* Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed—

(*a*) five per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 10 per cent of the capital of the company paying the dividends ;

(*b*) fifteen per cent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

[64] It was also held that since the general meetings of the company were conducted at Mauritius it could be presumed that the effective management was situated there. Also under the DTAA what mattered was where the place of effective management was situated in between the two countries and not with respect to other countries.

[65] *Ibid.*

Dividends derived by a resident of Mauritius from a company resident in India will be taxable at the rate of 15% on their gross amount.

However, a concessional rate of 5% will be available if the recipient of the dividend (i) is the beneficial owner of the shares in question and (ii) hold's directly at least 10% of the capital of the company paying the dividend. Authority found that the second condition was fulfilled but however there was a deliberation regarding the fulfillment of the first condition. It was on record that the entire shareholding of the Mauritian entities were with the British Bank and therefore the presumption shall be that the beneficial shareholding of the companies where with the British Bank. The authority found that the companies were established in 1994 soon after the revised Double Taxation Avoidance Agreement between India and the U.K. was notified. Hence the authority was of the impression that the Mauritian entities were established with the sole purpose of circumventing the Indo-U.K. DTAA and therefore the applications were rejected. Today, as dividends are tax-free in the hands of all shareholders, the impact of the ruling has been technically mitigated.[66]

One of the leading decisions of the Apex Court in this matter is that of ***Union of India v. Azadi Bachao Andolan.***[67] This case arose from an appeal from an order of the Delhi High Court which invalidated a circular of the CBDT regarding the Indo-Mauritius DTAA. As has been already pointed out, the capital gains arising out of alienation of shares will be taxed in the country where the person is resident.[68] By a Circular No. 682, dated March 30, 1994[69] issued by the CBDT, the Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India. Some time in the year 2000, some of the income-tax authorities issued show cause notices to some FIIs functioning in India calling upon them to show cause as to why they should not be taxed for profits and for dividends accrued to them in India.

The basis on which the show cause notice was issued was that the recipients of the show cause notice were mostly "shell companies" incorporated in Mauritius, operating through Mauritius, whose main purpose was investment of funds in India. It was alleged that these companies were controlled and managed from countries other than India or Mauritius and as such they were not "residents" of

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[66] S.115 O of the Income Tax Act, 1961 now provides that dividend paid by a company will he chargeable to income tax in the hands of the Company itself.
[67] [2003] 263 ITR 706 (SC)
[68] *Supra* n.9
[69] [1994] 207 ITR (St.) 7

Mauritius so as to derive the benefits of the DTAA. Thereafter, to further clarify the situation, the CBDT issued Circular No. 789 dated April 13, 2000[70] whereby it was clarified that wherever a certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAA accordingly. Two Writ petitions were filed in the Delhi High Court challenging the validity of Circular 789 and it was prayed that the Court directs the Government to take appropriate measures to check that the DTAA is not misused for fiscal evasion purposes. The petitioners also prayed that the court delimits the power of the CBDT to issue circulars which will be injurious to public interests. The Delhi High Court deciding in favour of the petitioners held that inasmuch as the impugned circular directs the income-tax authorities to accept a certificate of residence issued by the authorities of Mauritius as sufficient evidence as regards status of resident and beneficial ownership, it was ultra vires the powers of the Central Board of Direct Taxes. It held that an Assessing Officer in a given case has the power to lift the corporate veil for finding out whether the purpose of the corporate veil is avoidance of tax or not. The impugned circular was held ultra vires as it interfered with this quasi judicial function of the Assessing Officer.

The Court observed that Section 90 of the Income Tax Act, 1961 provides power to the Central Government to enter into Double Taxation Avoidance Agreements and such an agreement is brought into force by notifying it in the official gazette. The provisions of such a DTAA override the provisions of the Income Tax Act and if an agreement under Section 90 is inconsistent with the general principles of the Income Tax Act, it will prevail over the same.[71]

Thereafter the Court citing various judgments held that a circular promulgated by the CBDT under Section 119[72] of the Act was binding upon Assessing Officers. It was held by the Delhi High Court that Circular 789 had an effect of interfering with the exercise of discretion of the Assessing Officer

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[70] [2000] 243 ITR (St.) 57

[71] The Court pointed out that the Sections 4,5 and 9 of the Income Tax Act is subject to the Act and therefore an agreement entered into between India and any other country under Section 90 of the Act will have overriding effect.

[72] INSTRUCTIONS TO SUBORDINATE AUTHORITIES. Section 119 (1) The Board may, from time to time, issue such orders, instructions and directions to other income-tax authorities as it may deem fit for the proper administration of this Act, and such authorities and all other persons employed in the execution of this Act shall observe and follow such orders, instructions and directions of the Board :

Provided that no such orders, instructions or directions shall be issued—

(*a*) so as to require any income-tax authority to make a particular assess-ment or to dispose of a particular case in a particular manner; or

(*b*) so as to interfere with the discretion of the wali[Commissioner (Appeals)] in the exercise of his appellate functions and therefore is *ultra vires* Section 119. The Supreme Court held that what circular 789 did was to clarify an existing position under the DTAA and since the DTAA provisions have an overriding effect over the provisions of the Income Tax Act, the impugned circular is not *ultra vires* Section 119. The court also examined the contention of the respondents that the particular Indo-Mauritius DTAA was *ultra-vires* the powers of the Central Government that is conferred by Section 90 of the Income Tax Act, 1961. The Court answered this by stating that if the law made is under an authority derived from a statute, it can't be questioned merely because it fails in its objective.

As regards the question of legality of treaty is concerned, the court held that in absence of any clause in the treaty prohibiting a round tripping activity, it cannot be said that the treaty intended to the same. It was observed that assessing officers need not pierce the corporate veil to find out the true character of an entity since such a situation was not contemplated under the DTAA. Reference was made to the Indo-US DTAA where a limitation on benefits clause was inserted to avoid such a situation of *Treaty Shopping*. The Court held that if legislators' intention was to prohibit *Treaty Shopping* they would have put such a clause in the Indo-Mauritius treaty too.

This judgment has been subject to many criticisms since it indirectly validates tax evasion under the guise of a law. The Court has displayed an extreme case of judicial restraint and avoided answering the question of validity of the DTAA because of its misuse. Though it is a correct position of law under the separation of powers theory followed by India that the judiciary should not decide on matter relating to policy, however in the present case a patent illegality and flaw in the DTAA has been validated on the pretext that there was absence of legislative intent.[73] The attitude of the Court was such as to relieve itself of the responsibility of determining the question of validity of the DTAA and the illegal abuse of the same.

Suggestions to Improve Indo-Mauritius DTAA

To overcome the misuse of the provisions, the Indian government can deal it at the policy level by pressuring the Mauritius to incorporate Limitation of benefit (LoB) clause and the formation of a joint monitoring committee. Both the countries must also cooperate towards eliminating treaty

[73] Sohrab Erach Dastur, *Principles of Interpretation of issues in Double Taxation Avoidance Treaties*, see http://www.itatonline.org/interpretation/interpretation17.php

abuse by closely monitoring cross-border transactions and ensuring that no *Treaty Shopping* takes place. There is also a need of change in the judicial attitude since through the Azadi Bachao Andolan Case, the Supreme Court had legalised a patently illegal act.

- Limitation of Benefit

Limitations on benefits provisions generally prohibit third country residents from obtaining treaty benefits. Article 24 Indo- American DTAA[74] has a LoB clause, which provides that a minimum of 50% of the shareholding has to be with the residents of the country where the entity seeking benefits is located.[75].

- Joint Monitoring Committee

It is also suggested that a high power committee is setup to monitor the transactions that are aimed to evade taxes. There is a need of cooperation from the Mauritian authorities.[76] The Indian authorities should pressurise their Mauritian counterparts since protecting of their interests results in harm to the Indian economy. A high power committee consisting of members from both the countries should be constituted whose permissions should be required before investments beyond a certain level is made into the Indian capital markets. The SEBI should work it tandem with this Authority to monitor the inflow of cash in the markets.

The DTAA's though are great incentive in this era of globalisation and when the economic barriers are disappearing thick and fast, it should not be allowed to be a method for illegal tax evasion, such

[74] Article 24 - LIMITATION ON BENEFITS - *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…………

[75] Such a provision prohibits setting up of shell/post-box companies in a third country with the sole purpose of enjoying the benefits of the treaty thus preventing *Treaty Shopping* and round tripping. Recently LoB clauses have been incorporated in the Indo-UAE DTAA and Indo-Singapore DTAA

[76] The report of the Joint Parliamentary Committee on Stock Market Scam also stated the Mauritian Authorities were not willing to amend the DTAA since in their opinion would be detrimental to their investor friendly policies and that it would ultimately result in flight of capital from the Country

that it is causing great revenue loss to one of the party countries. In the present context when the Indian government has successfully negotiated for inclusion of the LoB clauses in the DTAA's with UAE and very recently with Cyprus, Indian should go headstrong and with much assertion upon Mauritius for the inclusion of LoB clause in the DTAA and for the formation of JMC. Such a development is very much expected in the near future with the recent visit of Central Board of Direct Taxation's (CBDT) Chairman to Mauritius for negotiations and from the fact that China-Mauritius treaty being amended very recently so as to equip it to be anti-abusive.[77]

[77] Deepshikha Sikarwar, *Cyprus May Cease To Be Capital Gains Tax Haven*, ECONOMIC TIMES, February 12, 2008 (Edn.)

CONCLUSION

Tax havens are small countries, they are affluent countries, and they have high-quality governance institutions. While all of these characteristics are to some extent associated with each other, it is noteworthy that poorly governed countries, of which the world has many, virtually never appear as tax havens. Their absence cannot easily be attributed to the desire on the part of poorly governed countries to conform to international tax norms, since these countries are not otherwise known for their conformity, and international tax norms are in any case not very well established. Instead, the most likely explanation is that tax havens are unsuccessful in the absence of high quality governance, and anticipating that, poorly run governments do not even attempt to become tax havens. Whether the absence of more tax havens is a good or a bad thing for the world as a whole is a fascinating question that lies beyond the scope of this paper, but from the standpoint of individual countries, the inability to tailor tax policies to maximum national advantage simply adds to the many woeful costs of poor governance.

Despite the clear limitations of the OECD's campaign against harmful tax competition, a similar multilateral movement to address international money laundering would prove more successful and fiscally equitable to nations of all economic conditions. The laws necessary to uncover illegal funds, such as moderate KYC laws, prove less invasive than those in the campaign against harmful tax competition, which require unlimited financial information exchange with tax authorities. Therefore, by adopting the less intrusive KYC rules, offshore tax havens risk deterring illegal investments exclusively, while protecting the revenues from legitimate deposits upon which their economic sustainability depends. In addition, these offshore financial centres actually stand to gain from the suppression of money laundering as it would entice a larger volume of legitimate investors, thus stimulating the economic growth necessary to remove these offshore tax havens from "developing nation" status. Most compelling, however, is that such a campaign would prove effective given the common global interest in eradicating the concealment of illegal funds offshore. Specifically, the ubiquity of offenses and the rising interest in uncovering terrorist finances around the world ensures the pervasive support needed for an effective and globally-unified movement against money laundering.