THE ECONOMIC TIMES

No more riding on tax treaties

13 Aug 2009, 0448 hrs IST,

The government, in its new Direct Tax Code, has sought to introduce provisions to prevent the misuse of double-taxation avoidance treaty that India has with a few countries. While the code will empower the government to enter into an agreement with any foreign country for relief on double taxation, it will also extend to enabling the purpose of exchanging information from the partnering country to prevent evasion or avoidance of income tax.

In double taxation, a company or an individual, who is a resident of one country and makes taxable gains in another, is obliged to pay taxes on those gains locally and pay again in the country in which the gain was made. Such treaties seek to avoid these instances.

Many foreign institutional investors route their investments through Mauritius or Cyprus into India to take advantage of the double taxation avoidance agreement. Both, India-Mauritius and India-Cyprus tax treaties provide that capital gains arising in India from the sale of securities can only be taxed in Mauritius and Cyprus. This means no capital gains tax on investments in securities routed through Mauritius and Cyprus, as they do not levy tax on capital gains.

In many instances, however, these agreements have been misused to evade taxes. This is called ‘treaty shopping,’ where usually residents of a third country take advantage of a tax treaty between two countries. The government is seeking to plug these loopholes.

“For the purposes of determining the relationship between a provision of a treaty and this code neither the treaty nor the code shall have a preferential status by reason of its being a treaty or law; and the provision which is later in time shall prevail,” the draft released Wednesday said. According to tax experts, the new provisions is in line with the US tax laws, which states that the domestic tax law, passed by the Senate will override any pre-existing treaty.

Lawyers said the new tax code is negative for the markets and international investments into India because of the uncertainty that it may create. “The proposed code upsets the basic structure of the existing tax jurisprudence developed over a period of over half a century.

The new code seems to have provided a back door entry to tax treaty override which clearly goes against principles of comity of nations and is likely to affect India’s international relations. Even the constitutionality of many of these provisions is indeed questionable,” said Nishith M Desai, international tax and corporate lawyer.