Tax Hotline

September 23, 2019

INDIA NOTIFIES PROTOCOL AMENDING INDIA-SPAIN TAX TREATY; INTRODUCES BASE PROTECTION AND TAX TRANSPARENCY MEASURES

- India recently notified the Protocol signed in 2012 to the India-Spain tax treaty
- Introduces unique Limitation of Benefit clause: provides for treaty-override to make Indian GAAR applicable, and beneficial ownership as pre-condition for availing treaty benefits
- New provisions to facilitate cooperation in information exchange and assistance in recovery of taxes
- Provision for mirroring transfer pricing adjustment to income of associated enterprise to eliminate double tax

The Indian government recently notified the protocol signed on October 26, 2012 (**"Protocol"**)[1] to amend the India-Spain tax treaty (**"Spain Treaty"**). The Protocol, *inter alia*, introduces a unique Limitation of Benefit (**"LoB"**) clause, and detailed provisions for cooperation in tax information exchange and tax recovery. It also introduces a provision for a mirroring adjustment for an associated enterprise in a state, where a notional transfer pricing addition has been made to a taxpayer's income under the laws of the other state.

The Protocol brings about the first amendment to the Spain Treaty since it was first signed in 1993. The changes indicate a deliberate shift towards measures for increasing tax transparency and cooperation, and for curbing tax evasion, much in line with international changes.

CHANGES AND ANALYSIS

A. Corresponding Transfer Pricing Adjustment for Associated Enterprise

The Spain Treaty already permitted notional enhancement of income of a taxpayer of a state resulting from transactions with a related entity (i.e. an associated enterprise) in the other state.[2] The Protocol adds a provision to allow a mirror adjustment to the income of the associated enterprise in the other state, based on the amount of tax charged on the taxpayer in the first state.[3] It also allows for consultation between the competent authorities of both states to determine the adjustment, if felt necessary.

The addition seeks to avoid double tax on the same income by rationalizing transfer pricing adjustments, looking at transactions holistically instead of at an enterprise level. It specifically provides for these adjustments to form part of negotiations during mutual agreement procedures under the treaty.

B. Cooperation in Information Exchange

The Protocol replaces Article 28 of the Spain Treaty entirely. The countries have agreed to a more extensive set of obligations to obtain and supply taxpayer information to each other. The standard of information to be exchanged has been diluted from information 'necessary', to information that is 'foreseeably relevant', for carrying out provisions of the Spain Treaty or domestic laws of the countries.[4] Further, it has been made clear that the information shared can be used for 'other purposes' when the laws of both states allow use for such purposes.[5]

The extent of protection on the information shared has been widened. The treaty earlier stated that information treated as a secret in the transmitting state would only be disclosed to tax authorities of the receiving state, that could only use it for designated purposes (except for disclosing in public court proceedings and judicial decisions). The Protocol extends this protection of information to all information received by a country – not only information treated as a secret under laws of the transmitting country.[6] This should facilitate smoother flow of information if countries feel safer trusting their taxpayer information in the hands of the other country. However, this could also result in higher administrative costs on the receiving state of such information if it needs to ensure that received information is adequately protected.

Instances where states can decline a request for information have been limited. Countries are now obliged to use their own information gathering tools to obtain information requested by the other, even if they don't require the information for their own tax purposes and cannot decline a request for information solely because it has no domestic interest in it. Neither can a country decline a request for information because the information is held by a bank or other financial institution, a nominee or person acting in an agency or fiduciary capacity, or because it relates to ownership interests in a person.[7] An explanation clarifies that countries can use other techniques as agreed upon by both competent authorities to obtain information which could be relevant for both countries, such as simultaneous examination, tax examination abroad and industry-wide exchange of information. These measures are geared towards creating a transparent international tax framework where secrecy can no longer be a tool for evasion.

Lastly but significantly, the Protocol gives the revised provision retrospective effect making it applicable to matters

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pre-dating the Protocol. There is no cut-off date or grandfathering provision, which begs the question of how this will impact cases pending adjudication in either state which did not have the benefit of wider information exchange provisions prior to the Protocol coming into force.

C. Cooperation in Tax Recovery

A new provision for assistance in collection of taxes, couched as a mandatory obligation, has been introduced. It requires that where a tax claim in one country is enforceable under its laws such that the taxpayer cannot stop collection of the tax, the other country on request of the competent authority of the first country is required to collect the tax according to its own procedures as if it is a claim in its own country. Further, for a tax claim that a country can take interim measures for under its own laws (such as freezing assets), the competent authority of the other country is bound to accept a request to take interim measures as if the claim is one arising under its own laws.[8]

However, the provision does not require a state to undertake administrative measures varying from its or the other country's laws or practices; take measures against public policy; assist if the other country has not exhausted all available avenues for collection or interim measures under its own laws; or assist where the administrative burden is disproportionate to benefit to the other country.[9]

This provision is intended to apply prospectively, and only to tax claims made after the coming into force of the Protocol, and only in cases where such claim is in respect of a tax year that commences after a date that is four years before the date on which the Protocol comes into force. Therefore, in case of recovery of taxes, the Protocol does not create retrospective rights which would have greatly prejudiced taxpayers.

D. Introduction of unique Limitation of Benefits clause

The Protocol has inserted a Limitation of Benefits ("**LoB**") provision by which India and Spain have contracted to apply their domestic anti-abuse rules, including in cases of treaty abuse. This is an express treaty override provision to allow application of India's domestic General Anti-Avoidance Rule ("**GAAR**") over beneficial treaty provisions, which complements a similar override provision under India's domestic law.[10] The issue of India's GAAR and its interaction with tax treaties has been a subject of intense debate, and consensus has come to rest on the view that the GAAR continues to apply unless adequate anti-avoidance provisions are present in a treaty. However, the Spain Treaty now negates the requirement of a standalone treaty LoB by incorporating domestic anti-abuse provisions directly.

The Protocol also clarifies that benefits under the treaty are only available to beneficial owners of income sourced from the other country. While intending to curb base eroding practices through this provision, the incorporation of a 'beneficial ownership' requirement may cause more confusion than desired and can prove to be highly litigious. The phrase is not defined in the treaty itself and has been interpreted differently by different jurisdictions leading to no consensus. A recent decision of an Income Tax Appellate Tribunal in India addressed the import of beneficial ownership of interest income received by a Cypriot entity from Indian debentures under the India-Cyprus tax treaty, and held that where the Indian tax authorities were unable to prove that (a) the taxpayer did not have exclusive possession and control over the interest, (b) the taxpayer had to seek approval or consent to invest in the debentures or (c) the taxpayer did not have complete discretion to utilize the interest income it received, unconstrained by any contractual, legal, or economic arrangements with any other third party; the taxpayer had to be regarded as the beneficial owner of the interest income and could avail treaty benefits.[11]

CONCLUSION

The Protocol introduces aggressive measures to promote tax transparency and to curb base erosion. How effectively these measures are implemented remains to be seen.

While the Protocol was notified by the Indian government on August 27, 2019, the date of entry into force is December 29, 2014. The reason behind this gap of five years is anybody's guess, but more importantly it brings up questions regarding the implementation of the Protocol. While many of the changes are machinery provisions, one aspect where this delay could have impact is in implementation of the LoB provision which allows for override by domestic anti-abuse provisions. Does this mean then that although the LoB provision was only notified in August 2019, it can operate to deny treaty benefits in respect of a transaction from 2017? The notification by the Indian government does not shed light on this aspect and leaves open potential for litigation for taxpayers affected in this 5 year period.

Another point for consideration is the interaction of the India-Spain tax treaty with the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("**MLI**") – a multilateral tax treaty that seeks to amend the bilateral tax treaties of its signatories to implement measures designed to better address multinational inter-jurisdictional tax avoidance. While India has signed and ratified the MLI, such that the date of entry into force of the MLI for India is October 1, 2019; Spain has only signed and has not ratified the MLI. Hence, the India-Spain tax treaty should continue to operate till Spain ratifies the MLI. Till such time, the new LoB provision providing an override for Indian GAAR will operate.

Once Spain ratifies the MLI and it operates to amend the India-Spain tax treaty, the new LoB provision is likely to be substituted with the anti-abuse provisions under the MLI. Hence, the new LoB provision is likely to apply only for a shorter period as an interim measure, till Spain ratifies the MLI.

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– Varsha Bhattacharya & Ashish Sodhani
You can direct your queries or comments to the authors

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[1] Ministry of Finance Notification No. 58/2019 dated August 27, 2019 https://incometaxindia.gov.in/communications/notification/notification58_2019.pdf

[2] Article 10, India-Spain tax treaty

[3] Article 10 Paragraph 2, India-Spain tax treaty

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[4] Article 28 Paragraph 1, India-Spain tax treaty

[5] Article 28 Paragraph 2, India-Spain tax treaty

[6] *Ibid*

[7] Article 28 Paragraphs 4 and 5, India-Spain tax treaty

[8] Article 28A Paragraphs 1, 2, 3 and 4, India-Spain tax treaty

[9] Article 28A Paragraph 8, India-Spain tax treaty

[10] Section 90(2A), Income Tax Act, 1961

[11] Golden Bella Holdings Ltd. v. DCIT, ITA No. 6958/Mum/2017 dated August 28, 2019

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