



# Entitlement to Treaty Benefits

*Limitation of Benefits Clause in Indian DTAA's and SLoB in Article 7 of MLI*

26<sup>th</sup> Course of Double Tax Avoidance Agreements

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# Entitlement to treaty benefits- limitations

- Art. 1 – access to treaty limited to residents of one or either CS

- Beneficial owner of income –

- Dividend, interest, royalties and FTS articles
- India-Israel Treaty (2015 Protocol) Art. 27A(3)

*Any benefit under this Convention shall not be granted to a person who is not the **beneficial owner of the item of income**.*

- Blackstone – whether Art. 13 exemption in SS for Gains derived on transfer of capital asset applies only to beneficial owner?

- Subject-to-tax condition

- Namibia Art 24(1) /24(2)

*If, in accordance with the provisions of this Convention, the right of India to tax income is limited and according to the Namibian tax laws, the income is **regarded as income from foreign sources and, therefore, exempted from Namibian tax**, India may tax such income **as if this Convention did not exist**.*

# *Entitlement to treaty benefits- limitations*

- Primary purpose test
  - *If affairs were arranged in such a manner as if it was **the main purpose or one of the main purposes** to take the benefits of this Agreement.*
  - Similar to MLI PPT; though 2<sup>nd</sup> limb (establishing benefit in accordance with treaty's object and purpose) absent.
  - If a CTA, this provision replaced by MLI PPT
- Legal entities not having **bona fide activities**
- Treaty override by domestic law concerning tax avoidance and evasion
  - E.g., Bhutan, Colombia, Israel, Korea, Malaysia, Thailand, Uruguay, Uzbekistan

# Entitlement to treaty benefits- limitations

- Remittance-based condition

- India – Singapore Treaty Art. 24

*Where this Agreement provides (with or without other conditions) that income from sources in a CS shall be exempt from tax, or taxed at a reduced rate in that CS and*

- *under the laws in force in the other CS the said income is subject to tax by reference to the amount thereof which is remitted to or received in that other CS and not by reference to the full amount thereof, then*

- *the exemption or reduction of tax to be allowed under this Agreement in the first-mentioned CS shall apply to so much of the income as is remitted to or received in that other CS.*

- Shell/conduit company provision

- India –Mauritius Treaty Art. 27A

- Applies only to Art. 13(3B) (gains from transfer of shares of co. resident)

- Shell /conduit company if

- If negligible or nil business operations or with no real and continuous business activities carried out in that CS

- If expenditure incurred in its RS < Mau Rs 15 lacs or INR 27 lakhs in the preceding 12 months

- Legal entities not having bona fide business operations

- India-Singapore Treaty (Art. 24A)

- Applies to Art. 14(3C) but also to Art. 14(3A) (shares prior to 1.4.17)

# Improper use of conventions

- Position prior to 2003
  - *Pacta sunt servanda* - domestic anti-abuse rules cannot override treaties
    - States' responsibility to preserve application of domestic anti-avoidance rules through treaty provisions or to agree that their application should not be affected by the treaties [OECD MC Comm on Art. 1, para 7 until 2003]
- OECD Model Comm. (2003 Update)
  - Domestic anti-abuse rules do not conflict with treaty obligations
    - Such rules for determining which facts give rise to tax liability, not addressed in treaties and not affected by them [OECD MC Comm on Art. 1, para 22.1]
  - **Guiding principle** [OECD MC Comm on Art. 1, para 9.5 (Para 61 2017 Update)]
    - Treaty benefits should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position, and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.



# OECD approaches (prior to 2003)

- OECD MC Comm. recommendations
  - Look through approach
    - Treaty benefit to a company only to the extent owned by the residents of the same State
    - Piercing the veil to examine the underlying beneficial ownership or use of funds
  - Exclusion approach
    - Aims to exclude certain offshore entities from claiming Treaty benefits unless they fulfill certain conditions, and denies such benefits to exempt or near-exempt companies or incomes
  - Subject-to-tax or liable-to-tax approach
    - Treaty benefits in the state of source only in respect of items of income which are subject to tax in the state of residence
  - Bona fide approach
    - substance of the transaction over its form in order to confer the benefits of the DTAA
- OECD MC Comm. (2017 Update)
  - Introduced PPT and SLOB Provisions pursuant to BEPS Project
  - States not obligated to extend treaty benefits where there is clear evidence of abuse *[para 80]*.

# Principal purpose test

**MLI-A. 7(1)** Notwithstanding any provisions of a CTA, a benefit under the CTA shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with *the object and purpose* of the *relevant provisions of the CTA*.

- Examples in Action 6 Report /OECD 2017 update
  - Substance based business purpose tests
- Signalling approach
  - Denying treaty benefits not in accordance with object and purpose, with or without PPT rule
- Purposive approach
  - In a mismatch between the wording and the object and purpose, latter takes precedence
- Shift towards a purposive interpretation of treaties
  - From ordinary meaning of the terms in a treaty in their context to ascertaining the overall fiscal impact as its *not the object of the treaty to support tax avoidance*

# Treaty shopping

- Art. 1 – Treaty applies to persons who are residents of one or both CS
  - Resident of a CS as defined in Art. 4
- Treaty shopping
  - Not defined in the OECD Model
  - Arrangements through which a person who is not a resident of a CS attempts to obtain benefits that a tax treaty grants to a resident of that State.
- Accessing indirectly the benefits of a treaty by third-country residents
  - Breach of reciprocity
    - Treaty concessions given by States to benefit their own residents, not residents of third states.
  - Reduced incentive to other States to negotiate treaties
    - If residents of third state are able to obtain benefits from a treaty between other States.
  - Lacking economic substance indicative of tax abuse
    - Tax avoidance likely where taxpayers do not undertake genuine business activities or transfer income to related parties in third states
- Treaty Preamble text modified by BEPS MLI
  - Without creating opportunities for **non-taxation** or **reduced taxation**
    - Through **tax avoidance or evasion**
    - (including **through treaty-shopping arrangements** aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)



# *Limitation of Benefits clause*

- OECD MC Comm on Art 1 para 20  
LOB article aimed at preventing persons who are not residents of either CS from accessing treaty benefits through the use of an entity that would otherwise qualify as a resident of one of these States
- US the forerunner –
  - first introduced in the US Model 1981
  - Germany – US Treaty (1989)
- LOB clause
  - restrict the entitlement to treaty benefits in relation to treaty shopping
  - series of objective tests (except for discretionary relief); purpose or intention not relevant
  - Adds certainty to taxpayers, but also complexity

# *Simplified LOB – MLI-A. 7(8) to(13)*

- MLI-A. 7
  - SLOB, unlike PPT, not a minimum standard.
- SLOB
  - opted by India
  - Modifies 12 Treaties
    - Added - Colombia, Denmark, Greece, Kazakhstan, Kenya, Namibia, Norway, Russian Federation, Slovak Republic
    - Replaced – Iceland, Uruguay
    - Romania Treaty (2013) -Art 27 replaced by PPT incl paras containing LOB provisions

# SLOB – notification design

State A	State B	Result
SLOB opted [7(6)]	SLOB opted [7(6)]	SLOB applies
SLOB opted [7(6)]	SLOB not opted [7(6)]	SLOB does not apply
SLOB opted [7(6)] but reserved entire Art 7 if other CJ not opted SLOB [7(16)]	SLOB not opted [7(6)]	Entire Art 7 does not apply
SLOB opted [7(6)]	SLOB not opted [7(6)] but opted u 7(7)(a)	SLOB applies
SLOB opted [7(6)]	SLOB not opted [7(6)] but opted u 7(7)(b)	SLOB applies for State A but not for State B

- SLOB not a minimum standard; it applies only when both CJs opt
- PPT applies even if SLOB is not opted for by either CJ
- A CJ can reserve Art 7 entirely if it opts for SLOB, but other CJ does not, and negotiate bilaterally.
- A CJ does not opt for SLOB but wishes PPT to apply has the option to agree that-
  - SLOB is applied by both CJs (symmetrical application).
  - SLOB is applied by only the other CJ (asymmetrical application)

# Qualified persons

- Disentitlement of treaty benefits **other than** a benefit
  - Determining residence of dual resident non-individuals [Art. 4(3)]
  - Giving corresponding adjustment following initial adjustment by other State [Art. 9(2)]
  - Non-discrimination benefit or a benefit that is not restricted solely to residents
- Unless the person is a **Qualified Person**
  - An individual
  - The State, or a political sub-division, local authority, agency or instrumentality
  - Company or entity whose principal class of shares regularly traded on recognized stock exchange
    - publicly traded companies subject to increased scrutiny, unlikely to be conduits
  - Non-profit organization or an entity providing retirement and ancillary/incidental benefits to individuals and is regulated as such by its resident State (i.e. charities and pension funds)

# Ownership test

- Non-individual (a QP) if
  - Persons who are **otherwise QP** own **directly or indirectly** at least 50% of its shares.
  - on at least half the days in 12-month period, including the time when benefit would be otherwise accorded
- Owners
  - must be residents of the same CS as the taxpayer
  - Minority shareholders also counted
  - No requirements for intermediate owners In cases of indirect ownership
- Ownership test incomplete without base erosion test
  - MLI SLOB contains only ownership test
  - Entities “locally owned” could **act as conduits**
    - Passing on their income as deductible payments to related parties in third jurisdictions



# Base erosion test

- Rationale: to deny treaty benefits on erosion of taxpayer's **tax base in Resident State**
- Iceland Treaty Art 24(2)
  - Provided that the QP not entitled to the benefits of the agreement if*
    - *more than 50% of the person's **gross income** for the taxable year is paid or payable*
    - ***directly or indirectly** to persons who are not residents of either of the Contracting States*
    - *in the form of **payments that are deductible** for the purpose of computation of tax **in the person's State of residence***
    - *but **not including***
      - *arm's length payment **in the ordinary course of business for services or tangible property** and*
      - *payments in respect of financial obligations to a bank incurred in connection with a transaction entered into with the permanent establishment of the bank situated in either of the Contracting States.*
- Test in Detailed LOB, absent in SLOB
  - MLI replaces LOB article with the SLOB – **base erosion test omitted** (Iceland, Uruguay)
- Gross income
  - Gross revenue less cost of goods sold
  - To be interpreted as per domestic law of residence state of taxpayer [Art 3(2)]
  - U

# Active conduct of business test– MLI-A. 7(10)

**MLI-A. 7(10)(a).** A resident of a Contracting Jurisdiction to a CTA will be entitled to benefits of the CTA

- with respect to **an item of income** derived from the other CJ, **regardless of** whether the resident is a QP,
- if the resident is engaged in the **active conduct of a business** in the first-mentioned CJ, and
- the income derived from the other CJ **emanates from, or is incidental to, that business.**

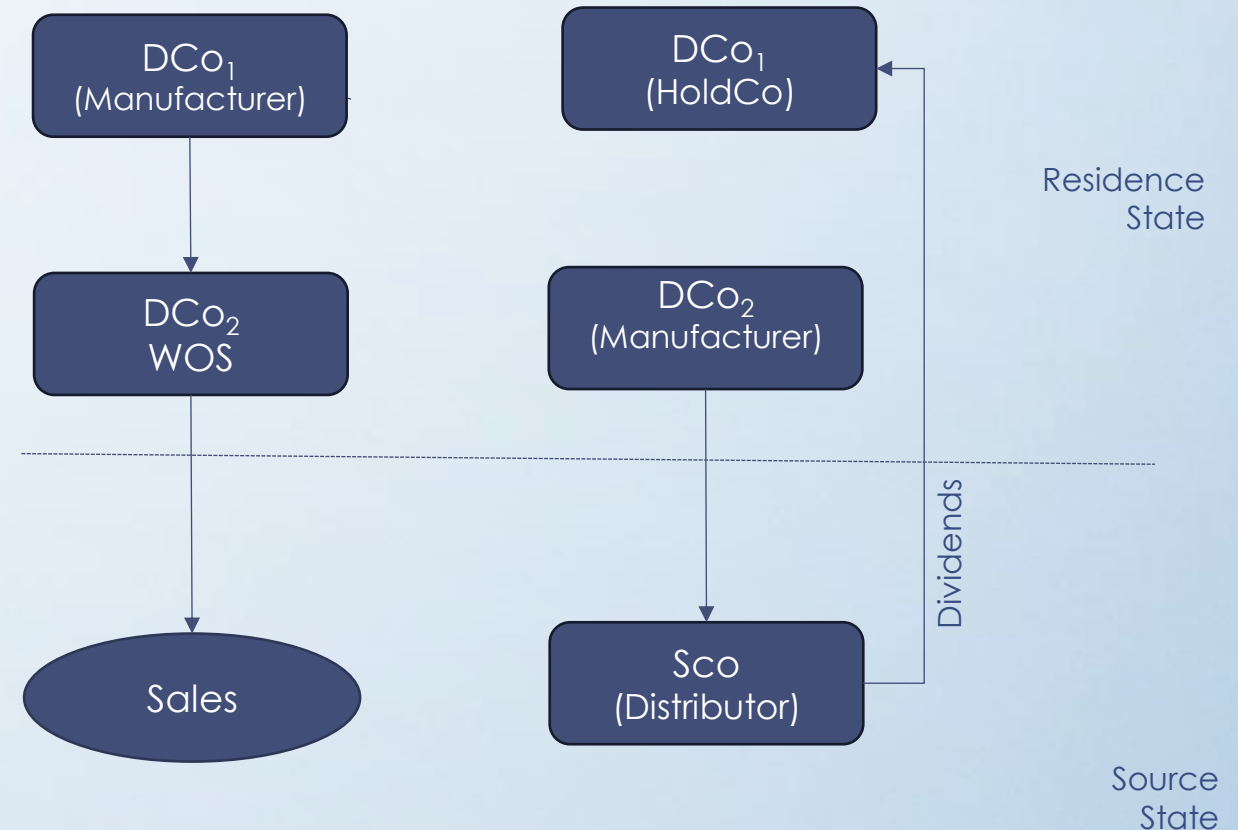
**MLI-A. 7(10)(b).** only if

- the **business activity** carried on by the resident in the first-mentioned CJ to which the item is related is **substantial**
- **in relation to the same activity or a complementary business activity** carried on by the resident or such connected person in the other CJ.

**MLI-A. 7(10)(c)** ..... activities conducted **by connected persons** with respect to a resident of a CJ to a CTA shall be **deemed to be conducted by such resident**

## Excluded activities:

- Operating as holding company;
- overall supervision/administration of the group;
- Group financing (incl cash pooling);
- Managing investments.



## Substantiality test –

to prevent interposing of company with insignificant business activities in the RS to avail of the treaty between R-S State.

# Active conduct of business test– MLI-A. 7(10)

- Emanates from-
  - Factual connection between the actively conducted business in RS and income for which benefits sought
- Incidental to:
  - Example- Temporary investment of working capital derived from the business

- Example (from the US Tech Explanation (1996))

*USFlower is a US Corporation. USFlower produces and sells flowers in the United States and other countries and has three subsidiaries resident in the other State, ForFlower, ForLawn and ForFish.*

*ForFlower distributes USFlower flowers under the USFlower trademark in the other State. ForLawn markets a line of lawn care products in the other State under the USFlower trademark.*

*In addition to being sold under the same trademark, ForLawn and ForFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products.*

*ForFish imports fish from the United States and distributes it to fish wholesalers in the other State.*

*For purposes of paragraph 3, the business of ForFlower forms a part of the business of USFlower, the business of ForLawn is complementary to the business of USFlower, and the business of ForFish is neither part of nor complementary to that of USFlower.*

# Derivative benefits – MLI-A. 7(11)

**MLI-A. 7(11).** A resident of a CS that is not a qualified person shall also be entitled to a benefit that would otherwise be accorded by the Agreement with respect to an item of income if,

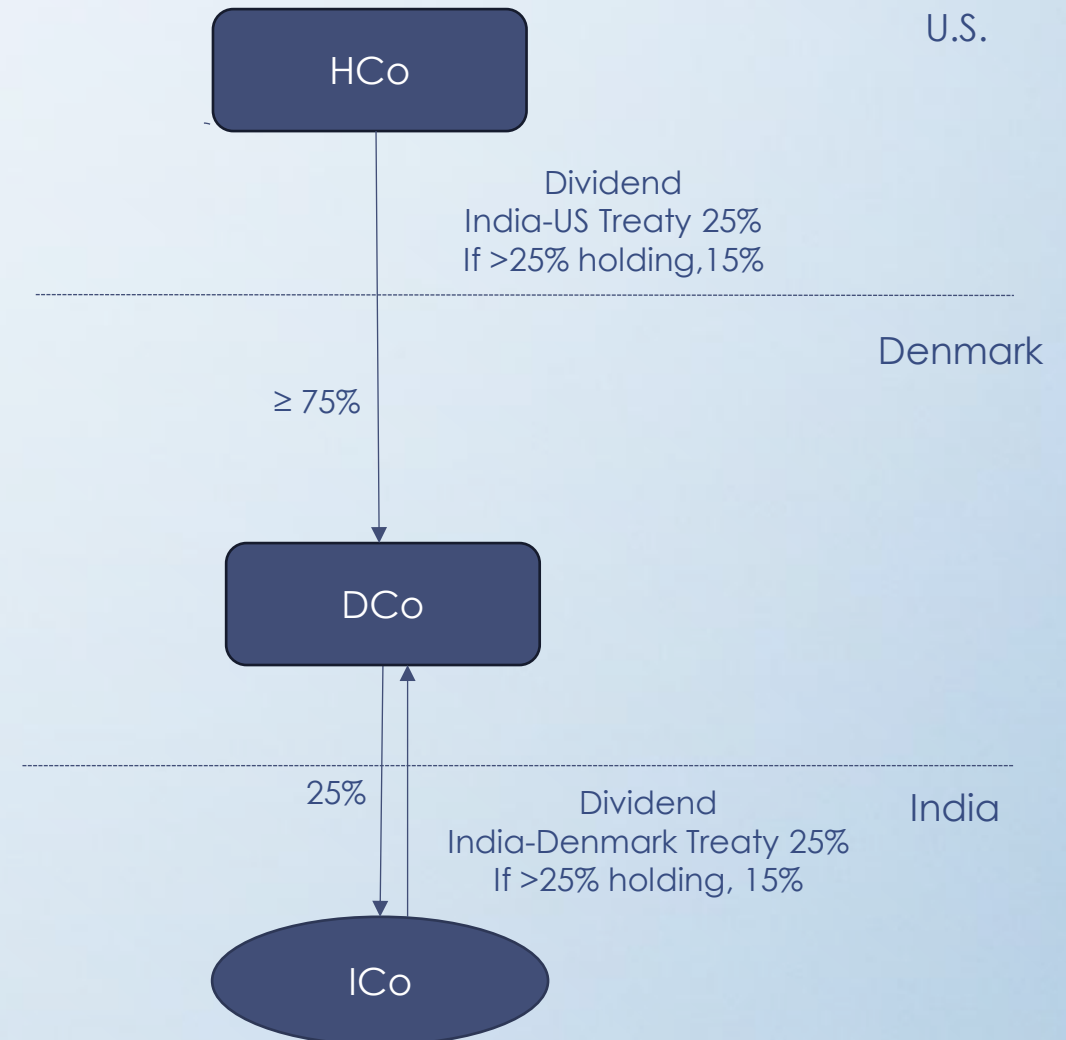
- on **at least half of the days of any twelve-month period** that includes the time when the benefit would otherwise be accorded,
- persons that are **equivalent beneficiaries** own, directly or indirectly, **at least 75 per cent** of the beneficial interests of the resident.

**MLI-A. 7(13)(c).** the term "equivalent beneficiary" means

- any person who would be entitled to benefits with respect to an item of income accorded by a CS under the domestic law of that CS, the Agreement or any other international instrument
- **which are equivalent to, or more favourable** than, benefits to be accorded to that item of income under the Agreement;

For the purposes of determining whether a person is an equivalent beneficiary with respect to dividends, the person shall be deemed to hold the same capital of the company paying the dividends as such capital the company claiming the benefit with respect to the dividends holds.

- Objective test
- Rationale
  - 3<sup>rd</sup> state resident unlikely to engage in treaty shopping if it were entitled to an **equally beneficial treaty benefit** vis-à-vis the source state with respect to income received directly from the source state,



# Discretionary relief

## MLI-A. 7(12)

If a resident of a CS is neither a qualified person (MLI-A. 7(9)], nor entitled to benefits under MLI-A. 7(10) or 7(11),

- Competent Authority of other CS may, nevertheless, grant
  - the benefits of the Agreement, or
  - benefits with respect to a specific item of income,
  - taking into account the **object and purpose of the Agreement**, but
  - only if such resident **demonstrates** to the satisfaction of such competent authority that
    - neither **its establishment, acquisition or maintenance**,
    - nor the **conduct of its operations**,
    - had as **one of its principal purposes** the obtaining of benefits under the Agreement.

Before either granting or denying a request made under this paragraph by a resident of a CS, the CA of the other CS to which the request has been made **shall consult** with the CA of the first-mentioned CS.

- Residual rule
- Subjective exercise
- Rationale

*“... with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a CS is **warranted by sound business practice or long-standing business structures** and does not necessarily indicate a motive of attempting to derive unintended Convention benefits [US Model (1996) Technical Expln]*

- LOB clause India-US Treaty

*24(4). A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention **if the competent authority of the State in which the income in question arises so determines.***

- MLI SLOB –
  - Determination convergence with PPT
  - Consultation with RS CA



*Thank You!*