

## **DTA as an accessory to crime**

**A man walks into a shop holding his young son's hand. He goes to the shelf, picks up two chocolate bars costing \$1 each. He asks his son to hold on to one of the chocolate bars as he walks over to the cashier. He intends to pay for only one**

**Chocolate bar and tenders 60 cents to the cashier. The cashier goes "no sir, it's \$1!". The man apologizes, pays the remaining 40 cents and leaves with his son.**

**The cashier was obviously so focused on the man's transaction that he completely overlooked the second bar of chocolate. To a certain extent, this is how DTAs are being used to facilitate tax evasion and money laundering on a global scale.**

**Double Taxation Agreements or treaties (DTAs) allocate the taxation rights of states so as to minimize or avoid double taxation. There are currently around 3500 such treaties in the world. Recently, there has been a growing concern that those treaties are being improperly used. DTAs are being exploited to facilitate the erosion of the fiscal base and contribute to the laundering of money. Consequently, states have been encouraged to enter into agreements with each other to foster the exchange of information or for mutual legal assistance.**

**Commentaries to OECD or UN based DTAs have been upgraded so as to ensure proper interpretation. The improper use of DTAs can give rise to avoidance (a civil wrong) or to evasion (a criminal wrong). Besides tax evasion, DTAs can be also used to facilitate money laundering. The international avoidance though civil wrong is widely documented and is being practiced by many big multinational groups. The same cannot be said about the criminal misuse of DTAs where there has been little or no prosecution. The absence of prosecution does not necessarily mean that crimes are not being committed through the treaties. It could well be explained by a lack of detection due to the wrong characterization of a transaction or to an inefficient use of mutual legal assistance regimes.**

**Philip Baker reflecting on the long title of DTAs which refers to "the avoidance of double taxation and the prevention of fiscal evasion", noted that "On first impressions, one might think that the tax treaty was only concerned with combating tax evasion and only with criminal conduct by taxpayers. This**

formulation of the long title has a history to it, and goes to the period before the Second World War when the distinction between tax avoidance and tax evasion was not so carefully made.” The distinction is often cited: Tax 1 avoidance is legal! 1 Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Papers on Selected Topics in Administration of Tax Treaties for Developing Countries Paper No. 9-A, May 2013.

while evasion is not. The dividing line is however blurry and extremely difficult to spot when applied to a transnational scale.

## **AVOIDANCE**

Avoidance at international level generally occurs through the network of DTAs and

is commonly referred to as Treaty Shopping. It “consists in a resident of a State, which is not party to a convention, establishing an entity within a state which is a party in order to take advantage of the provisions of that convention.” A more concise definition entails “a situation where a person who is not entitled to the benefits of a tax treaty makes use, in the widest sense of the word, of an individual or of a legal person in order to obtain those treaty benefits that are not available directly.”

Consequently, the practice of setting up companies in Mauritius to act as conduit into India and benefit from the India- Mauritius DTA fits those definitions. If

Company Z of Country Z (who is not a party to the DTA) establishes another Company Z1 in Mauritius. Company Z invests in shares in India, through Company

Z1 and is thus exempt from Indian CGT as per the Article 13(4) of the DTA as

Mauritius is the only country able to charge capital gains. However, Mauritius does

not charge CGT. That company will thus have reduced its liability to nil and would

have accessed a treaty to which it was not privy to when in Country Z. Company Z1

is set up in Mauritius solely to give Company Z access to the DTA and engages in little economic activity.

The aforesaid arrangement has often been challenged and tagged as an improper use of DTAs. The challenge stems from the fact that (i) the beneficial owner of the treaty-shopping does not reside in the country where the entity is created, (ii) the interposed company has minimal economic activity in the jurisdiction in which it is

located, (iii) the income is subject to minimal tax in the country of residence of the interposed company, (iv) the consequence of such transactions can result in a

reduction in the withholding taxes and the double non-taxation of income.

Nevertheless, in the *Azadi* case the Indian Supreme 2 Court found that:

i. domestic indian law specifically enabled the executive to negotiate and implement double taxation agreements rapidly and someone who was covered by a double taxation agreement could claim the benefit of the agreement even if the agreement were inconsistent with the Act;

!2 Union of India v. Azadi Bachao Andolan (263 ITR 706)

ii. The fact that the DTAS was used for Treaty Shopping did not mean that the agreement was ultra vires;

iii. Treaty Shopping might have been intended in order to encourage capital and technology inflows. The court could not hijack the discretion of the executive and decide on the duration of the Treaty Shopping as this depended on economic and political considerations.

A similar reasoning was applied in *ETrade Mauritius Ltd v Director of Income Tax*

*(International Taxation)* 12 ITLR 701, Praxair Pacific Limited ([2010 TPI 205]) and *Vodafone International Holdings B.V. (Vodafone NL)* [SLP (C) No.26529 of 2010].

Consequently, Treaty Shopping remains legal.

## **TAX EVASION**

Evasion on the other hand is both morally and legally reprehensible. The use of a DTA should in no way make it more acceptable. Recently, a two year investigation by the U.S. Senate Permanent Subcommittee on Investigations found that Credit Suisse allegedly “helped its clients create offshore entities and design transactions

to avoid arousing suspicion.” From 2001 to 2008, the Bank facilitated 3 tax evasion

by the U.S. customers and helped in the opening of undeclared Swiss accounts and

opening accounts for Offshore shell entities so as to camouflage the U.S.

ownership. The Bank even sent its Bankers to the U.S. to recruit new Customers and service actual ones without there being any paper trails. It is estimated that over 22000 U.S. customers had accounts with assets exceeding 12 billion swiss francs.

### **Detection problem**

Tax evasion presupposes a fraudulent misrepresentation. Consequently, avoidance

rules (Transfer pricing rules, arm’s lengths test, GAAR) will not always detect

evasion cases. If person A says to its local revenue authority that it is going to loan

money to person B in country B and he omits to say that person B is related to him

or falsely represents that person B is in fact not related to him, avoidance rules

will not apply. The detection of the evasion becomes even more problematic if person C from Country C is added to the equation.

<sup>13</sup> <http://www.levin.senate.gov/newsroom/press/release/subcommittee-details-swiss-bankinvolvement->

[in-us-tax-evasion-weak-us-response](#), last accessed on 27th February 2014

Problems of detection can also be exacerbated by a confusing avoidance with evasion. The complexity of the transactions involving more than just one country and the use of more than one DTA further contributes to the confusion and thereby

masking evasion

Use of legal tools

The Subcommittee also found that U.S. law enforcement agencies had failed to prosecute the numerous Swiss Banks that indulged in tax evasion and failed to utilise U.S legal means to obtain names of the tens of thousands of U.S persons whose identities are being concealed by the Swiss Banks. The 4 same finding could

probably be made in other jurisdictions as well.

Problem of Tracing

It is incredibly difficult to trace the funds back to its beneficial owner. The weblike nature of DTAs means that sources of funds would have to be traced through several states each having a distinct legal regime. This is time-consuming and can

yield no results if a particular jurisdiction has no legal assistance agreement or is slow to address the request of another state.

**MONEY LAUNDERING**

Money laundering through DTAs is distinct from evasion in that the fraudulent act is

to hide the illicit nature of funds irrespective of whether taxes are "adequately" paid. A drug dealer might invest the proceeds of his crime into a company in country A. The money will be transferred to country B and then to Country C and then comes back to Country A. After a series of successful placements around the world through treaty shopping or using the cover of DTAs, money is laundered. Alain Deneault recently referred to the Mafia reverting to the "Mille-feuille" technique which initially meant depositing funds from illegal trafficking in the accounts of actual laundries with no customers. Nowadays, the laundries have been replaced by large import-export companies, airlines or supermarket chains where criminal and legitimate revenue mingle.<sup>5</sup>

<sup>!4</sup> Offshore: Tax Havens and the rule of global crime, Alain Deneault, 2014, chapter 5

<sup>!5</sup> Ibid no.4

Criminals use multiple methods to conceal the illicit nature of funds such "fake lawsuits, transfers of funds from hidden circuits to legal networks with no apparent connection between the two, false winnings from casinos, concealment of dirty money in stock exchange transactions, and false loans secured by dirty money through a myriad of offshore shell corporations." <sup>6</sup>

It is enormously difficult to quantify the problem of money laundering. It is estimated that trillions of dollars circulate daily and almost half of it go through tax havens. <sup>7</sup> Tax havens are known to have interesting networks of DTAs. ( However, money laundering does not only occur in tax havens or low tax jurisdictions.)

**Solution**

Given the bulk of transactions, the sophisticated legal vehicles used and

jurisdictional problems, it is difficult to find a straightforward solution. Over the recent years, countries around the world have subscribed to numerous antiavoidance

rules, rules looking at the substance of a transaction rather than the form and international cooperation measures. I am of the view that there is no longer any need for further statutory innovations.

#### **MLA and TIEAS**

Given the side effects of Treaty Shopping and "Evasion", governments around the

world have been signing Tax Information Exchange Agreements and other Mutual Legal Assistance Agreements. I do not propose to go into the merits of those agreements. They remain, in my view, the only justifiable manner to counteract the improper use of the DTAs. Those agreements provide for the exchange of information between different states on tax matters. Some DTAs already have a clause providing for such exchange while other countries have signed specific agreements to that effect. EU Member States have Mutual Assistance Directive

<sup>16</sup> Ibid no.4

<sup>17</sup> Ibid no.4

77/799/EEC (MAD), as amended, in relation to direct taxes, certain excise duties and insurance premium tax. <sup>8</sup>

However, there is a general feeling that those mutual legal assistance provisions are not being efficiently used. For instance, Baker notes that exchange of information contained in Treaties are more used to counter tax avoidance and not tax evasion. He felt that other mutual legal assistance provisions are being used in

relation to tax evasion. <sup>9</sup> In my view, it is possible that exchange of information

provisions in tax treaties or revenue laws are not being used because the relevant authorities cannot see the fiscal dimension to it.

The effectiveness of those provisions is also questionable. For instance, some countries will prioritize their own domestic tax compliance rather than those of other states regardless of treaty obligations. Some countries can view tax evasion

with more leniency than others. The information collection is further limited by the powers conferred domestically which will not always tally with expectations of

the requesting states. 10

**No universal jurisdiction**

Even though evasion and money laundering through DTAs takes place at a global level, there can undoubtedly be jurisdictional problems when it comes to the prosecution of related offenses. Unlike piracy which occur on the high seas, such crimes do not have universal jurisdiction. This is understandable given that revenue is a sensitive issue that is closely linked to sovereignty. It is also unclear if

relevant authorities in a country would voluntarily passed on information to another country if it suspects that the other country is the victim of tax evasion.

**Extend the application of the Beneficial Ownership Test**

By contrast, the Beneficial Ownership requirement, embodied in articles 10, 11 and 12 of the DTAs ( OECD model), is an effective method of dealing with Treaty Shopping. In simple terms, the beneficial owner is the ultimate owner and distinguishes the proprietor of the beneficial rights from that of the legal rights.

The concept can be used to verify whether the true and ultimate owner of a

!8 Tax Fraud Sans Frontières - Tax Journal, Issue 730, 14



!9 ibid no.1

!10 ibid no.1

particular income is the treaty beneficiary. The courts in *Indofood* 11(in the UK), *Prevost Car* 2 (in Canada) and *Bank of Scotland* 13(in France) have recognised and

applied the beneficial ownership concept.

The criminal will have to use his money at some point. Determining who the beneficial owner is will obviously thwart money laundering or evasion through DTAs. Extending the beneficial concept to tax evasion or money laundering cases is

consequently necessary.

**Criminalise Avoidance**

As I mentioned above, the dividing line between avoidance and evasion is a very thin one. A daring solution might be to criminalise aggressive avoidance.

**Aggressive**

avoidance would concern large scale transactions devoid of any economic purpose

and not all avoidance transactions. In fact, to a certain extent, common law countries already criminalise tax avoidance. Many common law countries criminalise an agreement made between two or more persons to do something wrongful or harmful to another person or to do something unlawful. This offence is

known as Conspiracy. The tax planner who agrees with his client to schedule transactions through DTAs so as to prejudice the revenue of their country would technically be committing an offence even if the predicate wrong is merely tortious.

**Conclusion**

Tax related crimes using networks of DTAs concern all countries. The legal tools to

detect pre-ordained schemes already exist. It is important to distinguish between avoidance and evasion. It is equally important to prosecute tax evaders. However, a successful prosecution will only be possible upon a true appreciation of a

**!11 *Indofood International Finance Ltd. v JPMorgan Chase Bank N.A., London Branch (Formerly J P***

***Morgan Chase Bank, London Branch)* [2006] E.W.C.A. Civ. 158, S.T.L. 1195.**

**!12 *Prevost Car Inc. v. Canada* 2009 DTC 5053.**

**!13 *Conseil d'Etat, dated 29 December 2006, Ministre de L'Economie, des Finances et de L'Industrie***

***v. Societe Bank of Scotland* 9 1TLR 1.**

transaction, upon an efficient transnational enquiry through the medium of mutual

legal assistance and information exchange agreements and , more importantly, upon a global willingness to tackle the problem.

Taking into consideration the volume of transactions through DTAs, it might be easier to prefer a sniper approach to a shotgun approach (to focus on tracing targeted transactions instead of numerous ones). Moreover, being over-suspicious

about every transaction might defeat the purpose of DTAs by neutralizing the flow

of trade and investment in a particular country. However, the overriding prosecutorial concern should be the targeting of evasion and money laundering.

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