Tax Treaties

Interpretation, structure, and current issues

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Outline

- Basics of treaty law
- Domestic law and treaty law interplay
- Treaty applicability – Articles 1 and 2
- Equalization levy, Buyback tax
- Residence under treaty law – Article 4
- Force of attraction rule – Article 7
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- May be taxed vs. shall be taxed
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- Limitation of relief – Article 24
- Inconsistent application of treaty

Basics of treaty law

Plurality of laws

- Commonly, plural laws are applicable to a single transaction
- Stamp duty:
  - Any instrument that is executed in a State is leviable with stamp duty
  - Further, any instrument executed outside the State but relatable to the State is also leviable with stamp duty
    - E.g. Property in Delhi, instrument executed in Mumbai and then taken to Delhi
- Sales tax:
  - Pre-1950 – goods in Bombay, contract signed in Calcutta
  - Bombay will tax it since sale happens there (Bombay sales tax law would say that sale happens in Bombay if goods are in Bombay)
  - Calcutta will also tax the same as its law would state that sale happens in Calcutta if the contract is signed there

Plurality of laws *... contd.*

- Even in income-tax:
  - E.g. Pre-independence:
    - **Pondicherry Railway Company v CIT** [1931] 5 ITC 363 (PC) – payment received in British India by the assessee (a UK company) was liable to tax under the 1922 Act
    - **Anglo-French Textile Co. Ltd. v CIT** [1953] 23 ITR 101 (SC) – systematic procurement of raw material from British India amounted to business connection, and profits which were attributable to such operations, were taxable under the 1922 Act
    - **CIT v Currimbhoy Ebrahim & Sons Ltd** [1935] 3 ITR 395 (PC) – loan given by Nizam of Hyderabad (non-resident) to assessee located in British India did not give rise to business connection, nor did the interest so earned accrued or arose in British India
- So, multiple taxation arose even prior to the enactment of modern day direct tax laws; reason: laws are territorial in nature generally

Income-tax law

- Income-tax Act, 1961 lays down the law on income-taxation in India
- Section 5 – scope of total income – provides that:
  - Residents shall be taxable for:
    - income received or deemed to be received in India
    - income accruing or arising or deemed to accrue or arise in India
    - income accruing or arising outside India
  - Non-residents shall be taxable for:
    - income received or deemed to be received in India
    - income accruing or arising or deemed to accrue or arise in India

Income-tax law *... contd.*

- Section 9 – deemed to accrue or arise – provides for incomes that are deemed to accrue or arise in India, to non-residents
  - E.g. section 9(1)(i) – provides for incomes resulting through or from business connection, property, asset or source of income in India, or through the transfer of a capital asset situate in India
  - E.g. sections 9(1)(v)/(vi)/(vii) – deem interest, royalty, and fees for technical services to accrue or arise in India in certain situations

Tax residence

- Section 6 of the Income-tax Act, 1961 defines residence for the purposes of income-taxation
- Section 6(1) – an individual is a resident of India if (i) he is in India in the year for an aggregate period of 182 days or more, or (ii) he is in India for 60 days or more and has been in India for 365 days or more in the preceding four years
- Section 6(3) – a company is a resident of India if:
  - It is an Indian company, or
  - Its place of effective management (POEM), in that year, is in India
    - POEM means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made
  - Earlier law: instead of POEM, the clause provided for a company to be resident if during the year, the control and management of its affairs was situated wholly in India

Tax residence *... contd.*

- De Beers case:
  - Held:
    - in the nature of things a company, an abstraction, cannot breathe or eat or sleep or move about or do the things which would be factors in deciding where a natural person might reside ... where a company resides is the place where it carries on its real business
    - the real business is carried on where the central management and control actually abides. It remains to be considered whether the present case falls within that rule. This is a pure question of fact, to be determined, not according to the construction of this or that regulation or by-law, but upon a scrutiny of the course of business and trading

De Beers Consolidated Mines Ltd v Howe 5 TC 198

  - The decision pertains to a time when there was no definition of residence in the statute for a company
- UK law: a foreign incorporated company is treated as a UK resident if its ‘central management and control’ is located in the UK
  - Say, for example, a company incorporated in India, controlled and managed in UK, will be a resident of UK as per the above law. This company shall also be a resident of India as per Indian law on the basis of its incorporation in India.

Sources of income

- Countries can define source of income on different bases: e.g.:
  - Sale of tangible goods or services – where the title passes / whether payment is received or delivery made / where sales contracts are concluded etc.
  - Sale of employment services – where service is performed or rendered / where payer is resident / where payment is received / where service contract is made
  - Dividend income – where the paying company is resident / where underlying profits are sourced / where shares are registered
  - Interest income – where payer is resident / where debtor is resident / where loan contract is entered / where money is lent / where borrowed funds are used / where collateral assets are located / where interest is remitted from
  - Royalty income – where payer is resident / where the asset is used / where inventor resides / where intangible rights are registered / where agreement is made
  - Capital gains – where property is situated / where shares and securities are registered / in case of goodwill or trademark, where the business is carried out etc.

Sources of income *... contd.*

- *Illustration*:
  - Say, when a UK company earns interest income from an Indian borrower – UK would tax such income on the basis that the lender is a UK company. It can also tax it on the ground that the interest is received in UK.
  - At the same time, India would tax such income on the basis of source (i.e. the borrower) being located in India.
  - This is an example of source-source conflict (i.e. UK says received in UK and therefore sourced in UK, while India says that the payer is in India and therefore sourced in India)
  - This is also an example of residence-source conflict.

Double taxation

- Juridical double taxation
  - Dual residence (residence-residence conflict):
    - An Indian incorporated company which is a resident of India on the basis of incorporation, and at the same time be a resident of UK if its central management and control is in UK
  - Residence in one country and source in another (residence-source conflict)
- Economic double taxation
  - Two different taxpayers taxed on the same income in two or more countries e.g. dividend distribution tax, buyback tax
    - E.g. Trustee taxed in India, while the beneficiary taxed in the UK
    - E.g. Alimony paid to wife, taxed in the hands of wife, but not deductible in the hands of the husband
- In Customs law, double taxation doesn’t arise because each country taxes imports only – largely, the tax laws are the same for every country
- Similarly, in service tax or GST, services and goods imported are taxed and exports are not generally taxed, and hence double taxation doesn’t arise

Double taxation *... contd.*

- Can it be said that if the income-tax laws of every country are identical, then no double taxation would arise?
  - Yes, there will be no double taxation, provided that:
    - All countries tax only on the basis of residence, and the definition of ‘residence’ is unique so as to not result in any overlap, and countries do not tax on the basis of source, OR
    - Similarly, if countries tax only on the basis of source in a unique and non-overlapping manner, and do not tax on the basis of residence

Double taxation *... contd.*

- Remedying double taxation: tax treaties!
    - The countries sit together, negotiate, and decide how to distribute the tax revenues amongst themselves without levying the taxpayer with tax doubly!
    - Treaty negotiation: Sovereign + legal + political + economic exercise
- Tax treaty drafting:
    - Most treaties are modelled on either the OECD Model, or the UN Model Conventions, or are a hybrid of the two
    - US Model also prevalent, primarily in treaties entered into by the USA
    - Not drafted in the style of legislation
    - Each treaty varies from each other – great care required to focus only on treaty under question

Overcoming double taxation through tax treaties

Conflict	How the conflict arises	How treaties solve the conflict
Residence-Residence conflict	Taxpayer being a resident in both countries under respective domestic laws, and hence taxable in both countries on global basis	Solved by Article 4(2) by having unique definition of 'residence' through tie-breaker rules for the purpose of treaty
Residence-Source conflict	Taxpayer being a resident in one country which taxes on global basis, and has source of income in another country, which taxes such income on the basis of source.	Solved by distributive rules, read with Article 23
Source-Source Conflict	Both countries treat a particular income as arising from a source located within them, due to different definitions of source in the domestic law	Solved by unique definition of 'source' in the distributive rules e.g. Article 11(4) which states that interest shall be deemed to arise where the payer is located. The remaining conflicts arising out of different definitions of source in the domestic laws are solved by Article 21.

Interpretation of one treaty in the light of another

- Ordinarily, each treaty is a bilateral treaty and concerns only the Contracting States, and hence should not be compared with another treaty
  - E.g. treaties with landlocked countries might not contain Article 8 (shipping income)
- However, when the treaty is negotiated, India would always have the advantage of the experience of earlier treaty negotiations and thus, there is some connection / bearing between treaties.
- Therefore, if it can be established that there is a consistent treaty language emerging from the Indian treaty practice, then one treaty (such practice) may be used for interpreting another.

Treaty law vs. Pvt international law

- Conflict of laws / private international law is a different concept
  - Conflict of laws / private international law deals with the question that which of the two conflicting domestic laws would apply to a transaction / situation.
    - For example, seller is in London, while buyer is in India – whether the sale would be governed by UK law or Indian law?
  - In case of treaties, this question does not arise
  - The true question is that when a treaty provision states that the domestic law will apply, how is the same to be interpreted
- In case of treaty, each country applies its own domestic law

Domestic law and treaty interplay

International law and municipal law

- Tax treaties are a part of international law
- Gramophone Co. of India Ltd. v. Birendra Bahadur Pandey AIR 1984 SC 667:
  - Supreme Court had the occasion to deal with the right of transit of goods through India, of India's landlocked neighbour Nepal, under the international convention as also under the bilateral treaty.
  - But when the goods being transited were not allowed to be imported into India under its copyright infringement laws, the question arose as to whether the domestic law or the treaty law would prevail.
- Held:
  - Comity of nations requires that rules of international law may be accommodated in the municipal law <u>even without express legislative sanction</u> provided they do not run into conflict with Acts of Parliament.
  - When they do run into conflict, supremacy of legislature in making laws cannot be subjected to external rules. <u>National Courts will endorse international law but not if it conflicts with national law.</u>

International law and municipal law *... contd.*

- Takeaways from *Gramophone*:
  - International law automatically becomes part of the municipal law even without any express legislation.
  - However, in case of conflict between international law and enacted municipal law, municipal law will prevail
  - If legislation is made to implement the treaty – one would interpret the legislation to be in conformity with the international law
- Thus, can it be said that:
  - If there is a uniform international law, it becomes a part of the municipal law automatically, without the need for legislation?
  - If there is no uniform international law, the question does not arise!

International law and municipal law *... contd.*

- Klaus Vogel
  - International law does not confine levy only to residents or sources within the country. Thus, it permits extra-territorial levy of taxes i.e. it does not permit levy only on the basis of residence, or on basis of sources linked to residence
    - Resident being taxed on sources outside the country.
    - Non-residents are taxed on sources within the country.
  - Suppose international law prohibits levy of taxes on sources outside the country of residence or does not permit taxing the non-residents for sources within the country, then it is a different matter, but the position is not so
- Thus, current international law does not prohibit ‘extra-territorial levy of taxes’
- Contrast:
  - International law recognizes sovereignty of coastal States over territorial waters (countries respect each other’s sovereignty over territorial waters) – this is a settled uniform international law
  - This automatically becomes part of the municipal law. There is no need for a separate legislation to provide for it.

Entry 14 of Union List

- Article 246(1) – Parliament to legislate on matters enumerated in List I of Schedule VII to the Constitution of India

- Entry 14 of List-I in Schedule VII to the Constitution of India provides for:
    - Entering into treaties and agreements with foreign countries, and,
    - Implementing of treaties, agreements, and conventions with foreign countries

- Thus, Parliament can make a law for entering into a treaty as well as implementing it

Section 90 of the Act

- Section 90(1) – provides the Central Government to enter into an agreement with the Government of a foreign country for various purposes:
  - Relief of tax
  - Avoidance of double taxation
  - Exchange of information
  - Recovery of income-tax (to be read with section 228A of the Act)

- Section 90(2) provides that the provisions of the Act shall apply to the extent they are more beneficial to the assessee
  - With the exception of GAAR – sub-section (2A) inserted by Finance Act, 2013
- Are sub-sections (1) and (2) of section 90 corresponding to the first and second limbs of Entry 14 respectively? Perhaps yes!

Section 90 – the rationale and issues

- If section 90 is absent from the statute?
- Suppose income-tax is imposed through other statutes wherein provision similar to section 90 is not there?
  - Can it be said that even in the absence of the provisions of section 90, going by the rationale of Gramophone judgment, the provisions of tax treaty would have had application – though only to the extent the same does not come into conflict with the provisions of the Income-tax Act?

Section 90 – the rationale and issues *... contd.*

- Tax treaty entered into, in the absence of section 90, is of no consequence
  - Since sections 4 and 5 read with section 9 expressly provide for extra-territorial taxation of residents on their global income, and for non-residents on their incomes sourced in India – this being the municipal law, would override an *uniform* international law, even if it so exists
  - Also, there is no uniform international law providing for avoidance of double taxation.
  - Rather, there is uniformity in the international acceptance for extra-territorial taxation (refer residence and source slides supra), leading to double taxation
  - In the absence of a provision similar to section 90, sections 4 and 5 would prevail over any treaty. Thus, entering into the treaty would be of no consequence.
- Why this question is relevant:
  - E.g. Companies (Profits) Surtax Act, 1964 – as enacted, did not contain any enabling provision for the Central Government to enter into a treaty w.r.t. relief or avoidance of double taxation. Later, through Finance Act, 1965, section 24-A was inserted to provide for the same.
  - E.g. equalisation levy

Historical examples - India-USA

- Illustration: Treaty permitting India to tax, but domestic law not containing the corresponding provisions
  - Treaty provided that the definition of 'USA' and 'India' would include inter alia continental shelves respectively
  - Section 2(25A) of the income-tax Act, 1961, pre-Finance Act, 2007, included only union territory of Goa – there was no reference to continental shelf. Therefore, India would have included only territorial waters under such definition.
  - Hence, income earned by foreign companies from drilling operations carried out on the Indian continental shelf were not chargeable to tax under the Income-tax Act, 1961, though the treaty provided so. The enabling provision in the treaty was, thus, ineffective.
  - Finance Act, 2007, w.r.e.f. 25.08.1976 amended the definition of 'India' to include continental shelf also.
- Illustration 2: Treaty permitted India to tax royalty if the payer is in India
  - Under the domestic law, income from business connection alone was taxable u/s 9(1)(i)
  - Supreme Court held in **Carborundum Universal 108 ITR 335 (SC)** that knowhow delivered outside India, payment made outside India by a payer in India, there would be no business connection, and hence not taxable under domestic law

Treaty creating a charge / levy

- In case the Income-tax Act itself provided relief / exemption to a particular subject-matter of income, or did not cover it, the same would apply and treaty cannot prevail
  - Section 90(2) was inserted vide Finance Act, 1991 w.r.e.f. 1972

Treaty applicability – Articles 1 and 2

Article 1

- Persons covered – provides that the treaty shall apply to persons who are residents of one or both the Contracting States
  - Treaty applies only to residents – what about permanent establishments (PE)?
- Article 24(1) – the treaty may apply even to non-residents i.e. nationals
- Article 10(5) – extra-territoriality
  - Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except … even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.
  - Hunter Douglas v. The Queen 79 DTC 5340 (FCTD)
  - Caltex India v CIT [1952] 21 ITR 278 (Bombay)

Article 2

- Taxes covered – provides for taxes which are covered by the treaty
  - Provides that the treaty covers <u>taxes on income and capital</u>, with the scope of such taxes on income and capital defined
  - The taxes covered by the treaty are specifically enumerated, and it is further provided that the treaty also applies to any <u>identical or substantially similar taxes</u> which are <u>imposed after the signing</u> of the treaty <u>in addition to</u>, or in place of, the existing taxes.

  - What about equalization levy – whether it is a tax covered by Article 2 of India's tax treaties?
  - What about dividend distribution tax and buyback tax?

Equalization levy

Equalization levy – introduction

- Introduced as a separate levy in Finance Act , 2016 through Chapter VIII
  - Not forming part of Income-tax Act
- Subject of levy
  - Online advertisements, provision for digital advertising space or any other facility or service for online advertisement, and Any other service as may be notified by Central Government
- All considerations for any specified service received or receivable by non-residents subject to levy @ 6% on gross basis
- Levy to be deducted by and paid by the payer to the credit of the government
- Exemption u/s 10(50) provided to the payee
  - This exemption is obviously from the levy, if any, u/s 4 of the Income-tax Act, 1961.
- Obviously, this exemption will not apply to the levy under Chapter VIII of the Finance Act, 2016.
- In addition, if the payer is the PE of a NR, this levy also applies
  - PE defined u/s 161 of the Finance Act, 2016 - same as treaty definition

Need for equalization levy

- No income accrues or arises in India u/s 5
  - For online services, it is difficult to determine where the services are performed
  - Payment made from India but received outside India
- No income deemed to accrue u/s 9(1)(i) as “no business connection” in India (Right Florists – ITAT, Kolkata). It cannot be regarded as royalty or FTS (Yahoo India – ITAT, Mumbai).
- As per treaty law, in the absence of PE, advertisement receipts cannot be subject to tax in India (Pubmatic India - ITAT, Mumbai)
- Also, an enterprise cannot be said to have performed services without any physical presence (Piedras Negras Broadcasting Co. v Commissioner)

Constitutionality

- State List
  - Entry 55 – Taxes on advertisements other than advertisements published in the newspapers _and advertisements broadcast by radio or television???
    - Omitted by Constitution (One Hundred and First Amendment) Act, 2016 – subsumed by GST

- Union List
  - Entry 82 - Taxes on income other than agricultural income
  - Entry 92 C – Tax on services (inserted vide Constitutional Amendment Act, 2003, but never brought into force) – subsumed by GST
  - Entry 92 – Taxes on the sale or purchase of newspapers and on advertisements published therein – subsumed by GST
  - Entry 97- Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists. (read with Article 248(1), and 248(2))

Constitutionality *... contd.*

- The Chapter on Equalisation Levy (Chapter VIII of the Finance Act, 2016) extends to the whole of India except Jammu & Kashmir
- Some statutes extending to the whole of India
  - Interest Tax Act, 1974
  - Hotel Receipts Tax Act 1980;
- Thinking of the Legislature is that all of these statutes levy tax in the nature of ‘income tax’ and hence covered by Entry 82 of the Union List

Constitutionality *... contd.*

- Statutes extending to whole of India excluding J&K
  - Service tax levied vide Finance Act, 1994
  - Expenditure Tax Act, 1987
  - Gift Tax Act, 1958;
  - Wealth tax on agricultural land imposed by Finance Act, 1970
  - Inland Air Travel Tax Act, 1971
- These enactments are relatable to Entry 97 of the Union List
- Reason: Due to Article 370, the residuary power of the Union does not extend to Jammu & Kashmir
- This suggests that the Equalisation Levy is not an 'income-tax'
  - This has a bearing on deciding whether treaty would apply or not in cases where the equalisation levy is deducted on payments.

Constitutionality *... contd.*

- Service tax on such services already collected from the service recipient
- On the same transaction, based on "aspect theory", tax can be levied on the 'income' aspect –
  - E.g.: <u>expenditure incurred in a hotel stay</u> – expenditure tax levied by the Centre, but luxury tax levied by the State
  - E.g.: <u>land and building</u> – property tax levied by the State, but income-tax on income from house property, and wealth tax levied by the Centre
  - E.g.: <u>advertisements</u> – entertainment tax on cable TV levied by the State, and service tax levied by the Centre
- Taxes on income need not be imposed by Income-tax Act alone. It can be through any Central Act also like Finance Act
- Art. 245(2) – law enacted by the Parliament can have extra-territoriality
- Challenge to constitutionality, that it is beyond Parliamentary legislative powers, not possible

Other aspects

- Why wasn't the equalisation levy put in the Income-tax Act?
  - Could have given rise to treaty benefit being available to the payee
  - Problem of attribution of profits to the activities carried in India
  - This is not an income accruing or arising in India – putting as an income-tax is against the basic premise of sections 4 & 5 of the Income-tax Act
- Why not put it in Service Tax / GST?
  - The service recipient is already paying tax on the consideration
  - Input tax credit would be available to the payer – therefore there won't be any net gain to the Revenue

Other aspects *... contd.*

- Will service tax be included in the computation of levy?
  - Service tax does not form part of 'consideration' for the service
- A limited list just now – but they'll keep expanding the list
- Nomenclature of the tax ('equalisation levy') is not relevant
- Is the levy extra-territorial in nature?
  - No. The language of the levy under Chapter VIII is clear – the principle that when two views are possible, the one in favour of territoriality is to be adopted, is inapplicable.
  - Further, as explained above, Article 245(2) precludes any challenge to the levy on the basis of extra-territoriality.

Treaty applicability

- Act does not extend to J&K – points that it is not a tax on income under Entry 82 of List I
- Is it a tax covered by the treaties?
    - Article 2(3) generally lays down the list of taxes in both Contracting States which are covered by the treaty. (Indian treaties cover income-tax under the Income-tax Act, 1961)
    - Article 2(4) of treaties – Identical or substantially similar taxes imposed after the signing of the treaty
- Provision similar to s. 90 of the Income-tax Act, is essential
    - India being a dualistic country – mere treaty is not enough – section 90 of the Income-tax Act is needed to give effect to the treaty
    - Section 90 not borrowed by Chapter VIII of the Finance Act, 2016
    - Cue can be had from amendments made by Finance Act, 1965 in the Companies (Profits) Surtax Act, 1964 (added section 24A, which is similar to section 90 of the Income-tax Act), and Wealth Tax (Amendment) Act, 1964 (added section 44A to the Wealth Tax Act)
- Is this a tax on the non-resident, or the payer?
    - The Legislature seems to have put this as a levy on the payer, thus keeping treaty applicability at bay
    - Once income is there, tax may be levied on any person chosen by the Parliament (e.g. trustees)

Buyback tax

Buyback tax – legislative history

<u>Around 2000-01</u>

- Buyback provision S. 77A of the Companies Act, 1956 *(inserted in 1999)*
  - Issue in income-tax: dividend, deemed dividend, capital gains, capital receipt or business income?
- S. 46A of the Income-tax Act, 1961 *(inserted vide Finance Act, 1999)*
  - Gain arising to a shareholder from the buyback of shares by a company, taxable as capital gains
- S. 2(22) – exclusion from ‘dividend’ – Therefore, no tax leviable u/s 115-O or any other section as dividend

Consequences

- Shareholder not taxable as dividend, rather capital gains
  - Shares being held in an Indian company, ,the situs of shares is in India. Therefore, normally, the income from transfer of such shares would have accrued or arisen in India.
- Indo-Mauritius treaty
  - Capital gains taxable in the country of residence of the shareholder
  - Thus, capital gains arising to a Mauritian shareholder on account of buyback of shares done by the Indian company, was taxable only in Mauritius
  - Effectively, no tax paid on such buybacks – the period between 2000 – 2013 saw an unprecedented resort to buybacks by Indian companies where the investors were based out of Mauritius (or other countries having similar treaty provisions e.g. Netherlands, Singapore, Kenya)

Buyback tax – section 115QA

- S. 115QA inserted from AY 2013-14
  - 'Distributed income' paid for buyback, to be levied with 'additional income-tax'
- Two charging sections
  - S. 46A and S. 115QA
  - Not unusual to have multiple charging sections – e.g. section 4 and section 85 for super-tax (In Income-tax Act as enacted in 1961)
- S. 10(34A) inserted
  - Exemption granted to shareholder on income arising to the shareholder on account of buyback of shares as referred to in section 115QA
  - Obviously, this exemption is for the levy under section 4, read with section 46A, and will not extend to the levy under section 115QA

Section 115QA – analysis

- Section inspired / buoyed by the success of the model around s. 115-O (Dividend distribution tax)
- Section 115QA – tax on distributed income to shareholder
  - “buy back” means purchase by a company of its own shares in accordance with provisions of company law

Section 115QA – analysis *... contd.*

- 'Distributed income' – a misnomer
  - Income from such buyback, can only be that of the shareholder – it can never be the income of the company
  - Once there is income, income-tax is leviable. Who has to pay it depends on what the Parliament lays down.
  - Ordinarily, u/s 4, the scheme is that tax is levied in the hands of the person who has earned the income. (except cases where the statute expressly provides for levy of tax in another person's hands)
  - Thus, nothing prevents the tax on the income of the shareholder to be collected from the company if the Parliament so chooses e.g. the recently introduced equalisation levy
  - Nature of the tax is different from and should not be confused with the mechanism of collection of the tax
  - The levy is different from TDS – even when such TDS is on a gross basis and is final tax

Treaty applicability

- Article 10: Dividends
  - Limited right of taxation given to the source country i.e. country of incorporation of the company buying back the shares
- Article 13: Capital Gains
  - Varies from treaty to treaty
  - In some treaties, taxing rights given to country of residence of the taxpayer
  - "Gains from the alienation of any property to be taxed in the country of which the alienator is a resident"
  - "Alienation" to have a wide meaning – Klaus Vogel
- Why the doubt arises
  - Because the levy is on the 'distributed income' of the company, and called as an 'additional income-tax'
  - The words are consciously chosen to characterise this as a levy on the company, and not the shareholder

Treaty applicability *... contd.*

- True nature of the transaction is:
  alienation of shares by the shareholder
  - Truly, income is arising to the shareholder alone. Hence, the shareholder can invoke Article 13 of the relevant treaty.
  - Domestic law: s. 115QA – tax to be levied on the company
  - Treaty law: Article 13 – tax to be levied on the shareholder
  - How to reconcile the two provisions – S. 115QA is a machinery for collection and hence is irrelevant for deciding whether treaty benefit would be available to the shareholder.
- Nomenclature given to a tax is irrelevant
  - What is levied under s. 115QA is truly a tax on the transfer of a capital asset
- But: s. 115QA – non-obstante clause, does it override s. 90 also?
  - Both section 90 and section 115QA contain non-obstante clauses, and hence the question arises as to which of the two section prevails.
  - Having regard to the object of the two sections, our view is that s. 90 is not overridden.

Dividend Distribution Tax

- Section 115-O was inserted *(inserted by Finance Act, 1997)*
  - Definition of 'dividend'
- S. 115-O: additional income-tax to be paid by the company on any amount paid by way of dividends
- Legally, this levy is over and above the levy of tax on dividends u/s 4 r/w/s 56(2)(i)
- S. 10(34): exemption from the levy u/s 4
- DDT: a tax on the company, or the shareholder?
  - Dividend can be income of the shareholder alone
  - Actual nature: DDT is income-tax on the shareholder, collected from the company at the time of its payment

Treaty applicability for DDT

- Godrej & Boyce Manufacturing Co. Ltd. – 394 ITR 449 (SC):

  Our submission:
  - The question that treaty applies or not, didn't arise
  - In law, dividend is always the income of the shareholder – esp. for the purposes of treaty law
  - Company, while paying dividend to non-resident shareholders, should be able to avail treaty applicability and deduct tax at 10%
  - NR shareholder, who receives dividend whereon DDT has been paid by the company, should be able to claim refund for the excess over the treaty rate for the Indian tax department.
  - The decision is not an authority on the proposition that it is the income of the company which is taxed – however, it holds that to say it is the tax paid by the company on behalf of the shareholder is wrong.
- UOI v. Tata Tea – [2017] 398 ITR 260 (SC)
  - Court held that dividend is different from the income of the company – followed Bacha F. Guzdar v. CIT [1955] 27 ITR 1 (SC)

Residence under treaty law – Article 4

Article 4

- The Convention shall apply to persons who are residents of one or both of the Contracting States – OECD Model Convention, Article 1 / Persons Covered
- For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence ... – OECD Model Convention, Article 4(1) / Resident
- Article 4 deals with ‘residence’
  - Article 4(1) defines residence on the basis of domestic laws relating to domicile, residence etc.
  - Articles 4(2) and 4(3) provide for tie-breaker rules in case of persons who are residents of more than one countries, including the Contracting States

Article 4 – Temporal application

- Case study: Facts:
  - Taxpayer resides in State A until 1st September 2018, and then moves to reside in State B
  - State A tax year is from 1st Jan to 31st Dec, while for State B it is from 1st April to 31st March
  - Both states consider 180 days as the threshold period for tax residence, and both States regard the taxpayer to be a resident throughout the year, if this threshold is crossed. (no issue arises if the States' laws follow a split-year approach)
  - The taxpayer alienates an asset on September 15, 2018
- Analysis:
  - Period of dual residence – 1st April to 31st December
  - First tie-breaker – permanent home: Which date to apply the permanent home rule on–
    - on the date of alienation,
    - throughout the period of dual residence, or
    - throughout the period in which the tax years overlap i.e. 1st January 2018 to 31st March 2019

(Philip Baker – Double Taxation Conventions and International Tax Law, 3rd Ed.)

Article 4 – Temporal application *... contd.*

- Klaus Vogel: Para 82A, Pg. 254, Third Ed.:
  - The factors used to determine treaty residence under Article 4(2) must exist in principle during the period for which taxation is at issue (a tax-year or shorter period – see para 10 MC Comm. Art 4 though it erroneously gives an example which should be controlled by Article 4(1) instead of Article 4(2)). This is applicable, for example, in determining the centre of vital interests. Correctly are Avery Jones et al, supra m. no. 1 at 104, 110; see also BFH BstB. III 462 (1994). To the extent that such determination depends on where the taxpayer normally resides, the examination of a greater period of time may be necessary, see m. no. 78.

Article 4 – Temporal application *... contd.*

- OECD MC Commentary (2010) Paragraphs 4.2 and 4.3 to Art. 23A and 23B:
  - Resident of State R1 derives benefit from an ESOP granted to him
  - State R1 taxes it when the option is granted
  - The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise
  - The person is thus taxed by each State when he is a resident of that State and Article 4 does not deal with this situation as there is no concurrent residence
  - This can be reduced to a residence-source conflict if Art 15 is applied and the residence country gives credit even in subsequent year
  - *Does this mean that in case there is a residence-residence conflict, one has to look at the source definition and decide upon that first – the other Contracting State becomes the residence country consequentially?*

Article 4 – Second sentence

- Second sentence in Article 4(1) provides that the term ‘resident of a Contracting State’:

  “ … does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.”

- Meaning:
  - If a person is taxable in a Contracting State only on source basis, he shall not be a resident of such Contracting State
- Second sentence not there in the 1963 OECD Model Convention; Added in 1977 – the Commentary states that it was added for clarificatory purposes
  - Clarify that ‘any other criterion’ isn’t meant to cover source-based deeming of residence

Article 4 – Second sentence *... contd.*

- Klaus Vogel:
  - The second sentence primarily refers to individuals who under the domestic law of a State are deemed to be residents of that State although they don't live there permanently, but whose taxation is limited to income from sources therein
- Example:
  - Taxpayer resident in Netherlands and France – in the Netherlands-France treaty, it was considered as resident of France
  - While applying the Netherlands-Sweden treaty, it was denied the tax-residence certificate by Netherlands, stating the Netherlands-France treaty position

(Klaus Vogel and Kees Van Rad correctly criticize the stand of the Netherlands tax authorities).

Article 4 – Three state situations

- What if the taxpayer is resident in two or more States with which the Contracting State under question has different conventions
  - Bank having operations in the USA, was incorporated in Switzerland, but having central management and control in the UK – resident of both Switzerland as well as UK
  - IRS Ruling (Rev. Rul. 73-354): the Bank could choose between US-UK treaty and the US-Switzerland treaty – for the purposes of determining taxability of interest arising in the USA
    - Now: If Corporation A is treated as a resident of Country Y and not of Country X for purposes of X-Y treaty, and as a result, is not liable for taxation in Country X, it is not entitled to claim benefit under the USA-X treaty, because it is not a resident of Country X. However, the Corporation A is entitled to claim benefits under the USA-Y treaty – *Rev. Rul. 2004-76 – renders the Rev. Rul. 73-354 obsolete*
- The Netherlands-France-Sweden example in the previous slide is also a three State situation that arises out of the interpretation of Article 4.
  - Effect could be that it could result in double non-taxation

Force of attraction rule – Article 7

Force of attraction – introduction

- US IRS regulation 864:
  - Inspiration of the entire FOA
  - Broadly, if there is a PE and there is a source of income in the US, it is presumed that the source is effectively connected with the PE
- Illustration:
  - Tata Steel India has a PE in the USA engaged in manufacturing of coils
  - Another company in the USA pays royalty to Tata Steel India directly
  - USA shall presume that the royalty payment is also effectively connected with the PE

Force of attraction – introduction *... contd.*

- 1922 Act as amended in 1928 had followed full force of attraction
  - any profit arising to any person from sale in British India of any merchandise exported to British India shall be deemed to have arisen in British India
- FOA applied even in the absence of 'business connection'
- Despite the Act reading so, the Manual used by ITOs provided for taxation only of income that accrues through
- Enquiry Committee of 1936 recommended amending the provisions relating to full FOA on the following grounds
  - International practice was not to impose tax on income not accruing in the country
  - Departmental manual too provided for taxation only of income accruing in India
- Accordingly, law as amended in 1939 to provide for taxation of amount attributable to India, as it currently stands

Force of attraction under the Act

- Section 9 – concept of business connection
- Explanation 1(a):
    - "in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be **only** such part of the income as is **reasonably attributable to the operations** carried out in India"

The word 'only' restricts the scope of income chargeable to tax under section 9 – business connection

Income attributable to the 'operations', and not to the 'PE' or 'business connection'.
'Operations' has a wider import!

OECD v. UN Model Conventions

Art. 7(1) of the OECD Model Convention

...

If the enterprise carries on business as aforesaid, the profits that are **attributable to the permanent establishment** in accordance with the provisions of paragraph 2 may be taxed in that other State.

No Force of Attraction

Full Force of Attraction: does not find place !

Art. 7(1) of the UN Model Convention

...

If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to:

(a) that permanent establishment;

(b) sales in that other State of **goods or merchandise of the same or similar kind** as those sold through that permanent establishment; or

(c) **other business activities** carried on in that other State **of the same or similar kind** as those effected through that permanent establishment.

Limited Force of Attraction

Variants

- "Directly and indirectly"
  - E.g. Article 7(1) of India-UK treaty: ... the profits of the enterprise may be taxed in the other State but only so much of them as is directly or indirectly attributable to that permanent establishment.

- Indirectly – PE undertakes the work on sale contract executed with HO
- Treaties: China, Japan, Singapore, UK
- Position in law:
  - Linklaters & Paines v. ITO [2013] 56 SOT 116 (Mumbai - Trib.)
  - ADIT v. Clifford Chance [2013] 33 taxmann.com 200 (Mumbai - Trib.) (SB)

Variants *... contd.*

- Modifications in Article 7
  - The provisions of this paragraph shall, however, not apply if the enterprise proves that the above **activities could not have been undertaken by the permanent establishment** or **have no relation with the permanent establishment**. [Clarification at the end of Article 7(1) of India-China DTAA]
- Partial / Limited FOA
  - ... the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment or, (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment. [Article 7(1) of India-New Zealand treaty]

Full, limited, and no force of attraction

- Full force of attraction
  - Taxing all profits of the transactions in the source country, whether attributable to PE or not
- Limited force of attraction
  - Taxing profits on transactions that are of the same or similar kind as that effected through the PE
- No force of attraction
  - Taxing only those profits as are attributable to the PE

Shipping income – Article 8

Taxation of shipping business

- Travel routes span across several countries
  - Complexity of apportioning profits
  - Where to tax? Residence, Source, Place of Effective Management
- Tax at residence
  - But: Operations distributed across countries
- Tax in source country
- Tax at Place of Effective Management (POEM)
  - What is Place of Effective Management

Article 8

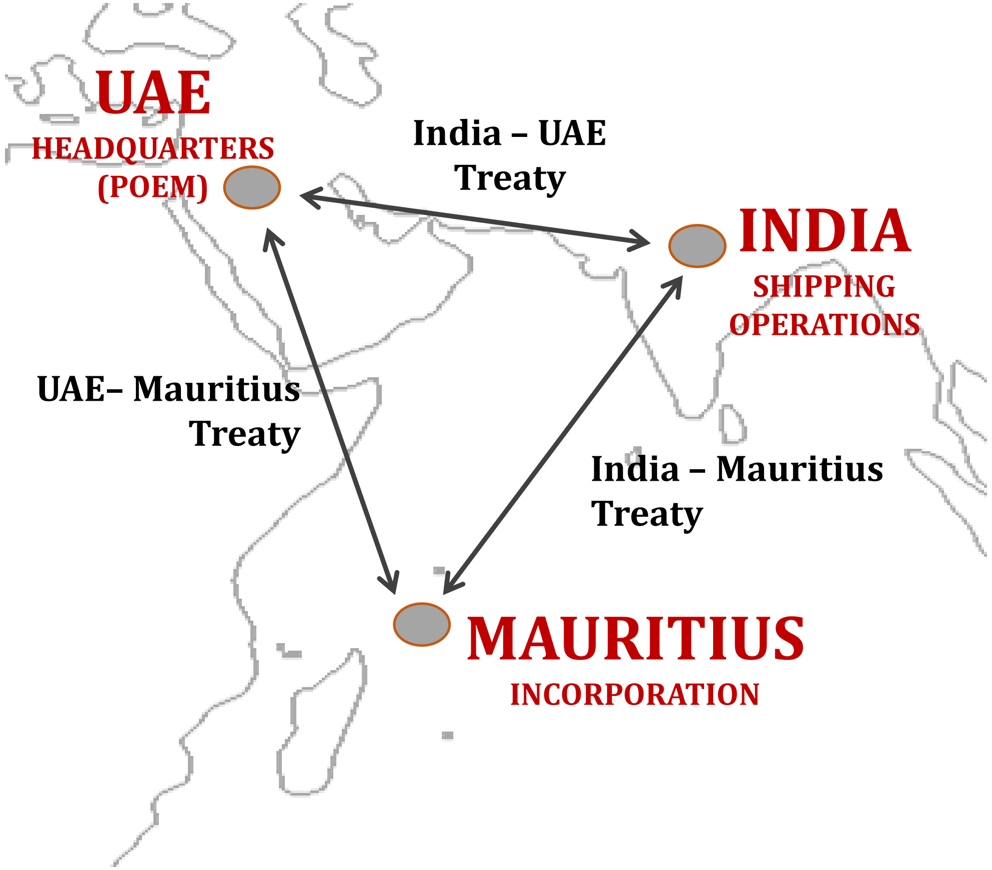
- OECD MC
  - Taxable in the country where the Place of Effective Management (POEM) is situated
- US MC
  - Taxable in the country where the enterprise is resident

- Many of the treaties follow the US Model – OECD MC Commentary itself recommends residence-based taxation

Point commonly overlooked: Though Article 8 refers to POEM, for applying the treaty, the taxpayer should be a tax resident of one of the Contracting States.

Case study

- India – Mauritius – UAE
- S Co Incorporated in Mauritius
- Headquartered in UAE
- Shipping operations in India
- Taxability in India?



India-Mauritius treaty

- Article 4: Resident
  - Person who is a tax-resident of either country based on the domestic laws of the country
- Article 8: Shipping and Air Transport
  - Income from shipping operations taxable where the Place of Effective Management is situated
- S Co is a tax-resident of Mauritius
  - Company tax-resident in Mauritius if (i) Incorporated in Mauritius, or (ii) managed and controlled from Mauritius
- POEM in UAE
- Article 8 of Indo-Mauritius treaty does not apply
  - Because application of Article 8 requires that the assessee is a resident of one Contracting State, while the POEM is in the other Contracting State

India-UAE treaty

- Article 4: Resident
  - Resident of India – as per Income Tax Act 1961
  - Resident of UAE – company incorporated in UAE and managed and controlled wholly in UAE
- S Co is <u>neither</u> a resident of UAE <u>nor</u> a resident of India
- India-UAE treaty does not apply
- Taxability in India → Mauritius-UAE treaty irrelevant

Interplay between Articles 7 and 8

- Assumption that if Article 8 does not apply, the treaty becomes inapplicable, is incorrect
- Since Article 8 is an exception to the rule contained in Article 7, being leges speciales – if the taxpayer is not covered under Article 8, it shall be covered by Article 7
- **Though Article 8 refers to POEM, for applying the treaty, the taxpayer should be a tax resident of one of the Contracting States.**

India-Switzerland treaty

- India-Switzerland treaty initially did not contain a distributive rule for shipping income in Article 8
  - Only air transport was covered
  - Amended to include shipping income as well in 2011 – now, such income is taxable on residence-basis only
  - Reason: landlocked country?
  - But India's treaties with other landlocked countries such as Uganda, Kazakhstan, Turkmenistan etc. contain shipping income clause
  - ADIT v. Mediterranean Shipping Company [2015] 54 taxmann.com 112 (Mumbai - Trib.)

“May be taxed” v. “Shall be taxed”

Historical background necessary

- Treaties have a historical background and legacy:
  - Many of them are based on a conventional understanding of international tax treaty law
  - E.g. 'may be taxed' (discussed in later slides) – if one simply reads the language without going into the context and background of international law, it would be interpreted incorrectly like the SC decision has done, it is submitted with respect;
  - Historical background is important, especially in case of terms which have acquired a well-defined and accepted meaning in international tax treaty law
- Domestic courts, while interpreting tax treaty law, should march hand-in-hand with international decisions particularly from courts of stature

Examples of terms used

- Terms used for determination of taxing rights
  - “Shall be taxable only in” e.g. Arts. 7(1), 12(1), 18
  - “May be taxed in” e.g. Arts. 6(1), 10(1), 11(1)
  - “May also be taxed” e.g. Arts. 10(2), 11(2)

Illustration of terms used in Articles – OECD MC

- Article 6(1) – Income derived by a resident of a Contracting State from immovable property … situated in the other Contracting State **may be taxed** in that other State.
- Article 7(1) – Profits of an enterprise of a Contracting State **shall be taxable only** in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.
- Article 8(1) – Profits from the operation of ships or aircraft in international traffic **shall be taxable only** in the Contracting State in which the place of effective management of the enterprise is situated.
- Article 13(1) – Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State **may be taxed** in that other State. .
- Article 13(3) – Gains from the alienation of ships or aircraft operated in international traffic … **shall be taxable only** in the Contracting State in which the place of effective management of the enterprise is situated
- Article 19(1)(a) – Salaries, wages and other similar remuneration paid by a Contracting State to an individual in respect of services rendered to that State or subdivision or authority **shall be taxable only** in that State.

Our understanding

- Distributive rules (Articles 6 to 21), read with Article 23
  - The broad hypothesis or assumption underlying these is:
    - Residence country will exercise full right of taxation, subject to certain exceptions
    - Source country will tax it, and residence country will eliminate double taxation – for example, a US Bank having a branch in India – India will tax only the profits attributable to India, while USA will tax the global income and eliminate double taxation by credit method
    - Per contra, if the US bank does not have a PE (or, source of income other than dividends, interest, and royalty) it shall be taxable only in the USA under Article 7(1)

Meaning of the phrase

- The expression "may be taxed" is not defined in the Act or in the MCs
- View 1 – "may be taxed" in a Contracting State does not connote an exclusive right of tax in a particular country and both the Contracting States have the right to tax the particular income in accordance with their domestic laws
  - OECD MC Commentary (2010) Para 4 in Article 10
  - S Mohan, In re (2007) 294 ITR 177 (AAR)
- View 2 – "may be taxed" connotes an exclusive right of taxation
  - CIT v. R M Muthaiah (1993) 202 ITR 508 (Kar)
  - CIT v. Vr SRM Firm (1994) 208 ITR 400 (Mad)
  - In DCIT v. Patni Computer Systems, the Tribunal cited the HC judgments of RM Muthaiah and Vr SRM Firm and observed that the SC in Azadi Bachao Andolan upheld the reasoning of these judgments

Judicial rulings

- Kulandagan Chettiar (2004) 267 ITR 654 (SC)
- Turquoise Investment (2006) 299 ITR 143 (MP) – approved in 300 ITR 1 (SC)
- Essar Oil Ltd ITA NO.2441/MUM/2007

Domestic law provisions

- Section 90(3) – Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.
- Explanations:
  - Explanation 3 provides that the term defined through the notification shall be deemed to have effect from the date on which the said agreement came into force
  - Explanation 4 provides that where any term used in an agreement entered into under sub-section (1) is defined under the said agreement, the said term shall have the same meaning as assigned to it in the agreement; and where the term is not defined in the said agreement, but defined in the Act, it shall have the same meaning as assigned to it in the Act and explanation, if any, given to it by the Central Government.

Notification u/s 90(3)

- Notification under section 90(3) was issued which provides for the following:
  - "...where an agreement entered into by the Central Government with the Government of any country outside India for granting relief of tax or as the case may be, avoidance of double taxation, provides that any income of a resident of India "may be taxed" in the other country, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961 (43 of 1961), and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement

Essar Oil – ITAT Mumbai

- Essar Oil v Addl CIT [2014] 42 taxmann.com 21 (Mum) – ITAT held:
  - There are two schools of thoughts: first representing the international practice as argued by RA and the second is the Indian jurisprudence relied upon by the Tax Payer
  - The SC in UOI v. Azadi Bachao Andolan 263 ITR 706 (SC) inhabited placing reliance on international commentaries and texts. Hence, the former school of though has to be accepted
  - The SC and HC rulings on the subject were not on interpretation of the Act and hence the meaning provided in the Notification is not in violation any law
  - The Notification is only clarificatory and does not create a fresh charge. Hence it is will have retrospective operation from April 2004 (when section 90 (3) was inserted)

Residual rule – Article 21

Article 21 – Other income

- OECD Model – Article 21(1) – Items of income, wherever arising, not dealt with in the foregoing Articles shall be taxable in the State of residence
- Issue:
  - Interpretation of the term ‘items of income … not dealt with’
  - Interplay between various Articles which have their own definitions e.g. Article 12(3) which defines royalty – in case such definition fails, will the income go to Article 21? Yes, it cannot be claimed that it would go outside the treaty.
  - Meaning of ‘wherever arising’ – it ensures that the source country cannot say that it is not arising in the residence country, and therefore it can tax it
  - In case the income arises in a third country, its taxability would be governed by the treaty between the country of residence and such third country.
- UN Model – dilutes + destroys the scheme / logic behind Article 21 by allowing the source State also to tax as per its domestic law
  - Thus, the basic pretext that the treaty should clearly lay down distributive rules which eliminate double taxation, is diluted.
  - But anyways, credit would be available

Limitation of relief

India-Singapore treaty

- Countries like Singapore impose tax on certain taxpayers on a 'remittance' basis
- Limitation of relief provided for in Article 24 of the treaty
  - Where this Agreement provides (with or without other conditions) that income from sources in a Contracting State shall be exempt from tax, or taxed at a reduced rate in that Contracting State and under the laws in force in the other Contracting State the said income is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State 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 Contracting State shall apply to so much of the income as is remitted to or received in that other Contracting State.
- Intent: to prevent the offshore income of residents of Singapore from going tax-free in both the countries

India-Singapore treaty *... contd.*

- Onus is on the taxpayer to prove that remittance has taken place
  - Abacus International v DDIT (2013) 34 taxmann.com 21 (Mumbai-Trib)
- Interplay between Article 24(1) of the treaty and source-rule laid down in Articles 11, 12 etc. (wherein the payer's country is the one where the interest or royalty is deemed to 'arise')
  - SET Satellite Singapore v. ADIT (MA No. 520/Mum/2010)
- M.T. Maersk Mikage v. DIT [2017] 291 CTR 184 (Gujarat)
  - Assessee claimed that its freight receipts from shipping business were not taxable in India since Article 8 applied to the same
  - AO held that since receipts were not remitted to Singapore, benefit u/A 8 won't be available
  - Such income was assessable in Singapore on accrual basis and not on basis of remittance
  - Held that Article 24(1) won't apply

Inconsistent application of treaty

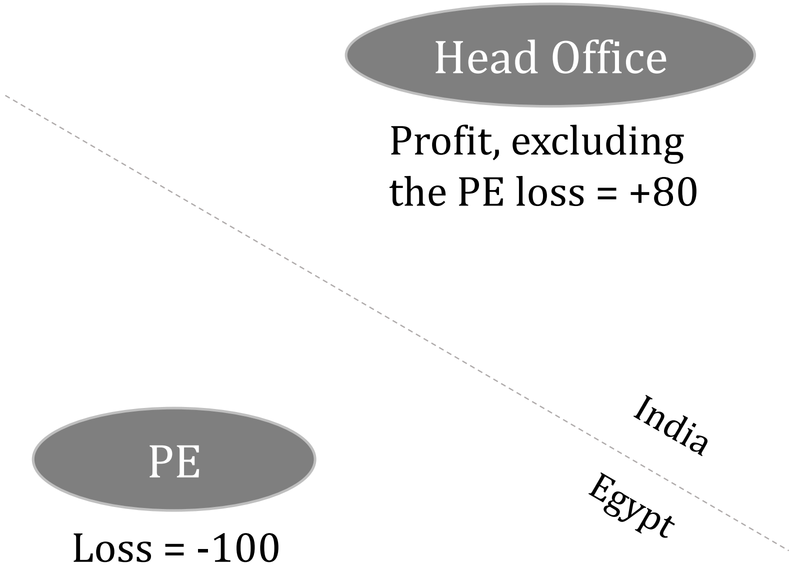
Act vs. treaty

US Treasury Technical Explanation on India-US Treaty:

- A taxpayer may always rely on the more favourable Code treatment. This does not mean, however, that a taxpayer may pick and choose between Code and treaty provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of India has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses which would earn taxable income under the Code but which do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be taxable. The loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17 I.R.B. 1984-1, 10.) If the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States which is not effectively connected with any of his business activities in the United States.

Losses of a PE

- Whether where the treaty follows exemption method for relief of double taxation, the losses arising in a PE could be set off in the residence country?
- The issue doesn't arise in case of credit-based treaties
    - Most Indian treaties are credit based, except e.g. Egypt, Bulgaria, and some others where India follows the credit basis while the other country grants exemption e.g. Austria, Belgium and Turkey



Losses of a PE *... contd.*

- If the tax system is based on territoriality principle (e.g. France – company tax, which is imposed only on income arising in the domestic territory), a general bar on the consideration at home of losses incurred abroad is logically consistent
  - Klaus Vogel: Third Ed., Pg 1182 M. No. 72
- DCIT v. Patni Computer Systems [2008] 114 ITD 159 (Pune)
  - Held: Section 90(2) only grants relief, and does not impose tax liability
  - It is obviously to the advantage of the assessee that it is taxed in India on the basis of its worldwide income, which included losses incurred abroad, and not to invoke the provisions of the India-Japan DTAA
  - A double-dip of foreign losses may occur. In years when the PE has losses, it may claim deduction of the same in the home country, while in the subsequent years, when the PE may make profits, the same would remain outside the purview of taxation in the home country.
  - The position may be undesirable, but it is inevitable given the existing legal position – the remedy does not lie with the Tribunal (judiciary)

Thank you. Questions?