# Contentious issues around double tax treaties, their interpretation and implementation.

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# TAX
## TREATIES

# Agenda

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- Introduction to treaty law
- Equalisation levy
- Buyback of shares, and DDT
- Situs of intangibles
- How treaties overcome double taxation
- Combined application of Articles 7 and 8
- Corresponding and secondary adjustments
- Force of attraction

# Introduction to treaty law

- Introduction to treaty law
- Structure of tax treaties
- Distributive rules

# Treaty law – an introduction

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- Tax treaties entered into to, inter alia, to prevent juridical double taxation
  - Can it be said that no treaties would be needed if the tax laws of every country were alike and same in all respects?
  - Juridical double taxation may arise in three situations:
    - Assessee being a resident of two Contracting States, and both subject him to tax on global income (Residence-Residence conflict)
    - Assessee being a resident of one Contracting State, but derives income from another Contracting State (Residence-Source conflict)
    - Assessee not a resident of any Contracting State, but both States levy tax on income derived from a source located there (e.g. Assessee has a PE in a Contracting State, and such PE has income arising in another Contracting State)
- Most treaties are modelled on either the OECD Model, or the UN Model Conventions
- Most tax treaties are bilateral (though there are few multilateral treaties as well)

# Treaties – Structure

- Chapter I and II – Regulate the requirements for application of the treaty
- Chapter III – Distributive rules regarding income taxation
- Chapter IV – Distributive rules regarding wealth taxation
- Chapter V – Legal consequences of the rules of Chapters III and IV
- Chapter VI – Additional rules regarding non-discrimination, MAP, exchange of information, entry into force, termination etc.

# Treaties – Application

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- Important treaty provisions:
  - Article 1 – "This Convention shall apply to persons who are residents of one or both of the Contracting States."
  - Article 2 – taxes which are covered by the treaty
  - Article 3 – Definitions
- Article 4 – Residence
  - Residence based on domestic law definition
  - Tie-breaker rules – unique residence needed for the purpose of the treaty

# Treaties – Distributive Rules

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- Distributive rules – four general categories:
  - Rules referring to income from certain activities (or, active incomes), including business (Art 7), independent personal services (broadly, income from profession as against income from business) and dependent personal services (Arts 14-15), agriculture and forestry (Art 6)
    - Rule governing shipping (Art 8) is a *leges speciales* i.e. a special exception, to the business profits rule. Similarly, the rule governing entertainers and athletes is a special exception to the rules on independent and dependent services, and in some cases, even to the business profits rule.
  - Rules referring to income from assets (or, passive incomes), including dividends (Art 10), interest (Art 11), royalties (Art 12), and income derived from immovable property (Art 6)
  - Rules referring to capital gains (Art 13)
  - A residuary rule covering income not dealt with in the foregoing three categories (Art 21)

# Equalisation levy

- Introduction
- Constitutional validity
- Treaty applicability

# Equalisation levy – Introduction

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- Introduced as a separate levy in Finance Act , 2016 through Chapter VIII – not forming part of Income-tax Act
- Subject of levy
  - Online advertisement
  - Provision for digital advertising space or any other facility or service for online advertisement,
  - 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

# Attempts to levy income tax on online advertisements

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- 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)

# Options – Action Plan 1 – BEPS

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- Primarily recommended amendment (both in the treaties and the domestic laws) to the definition of 'permanent establishment' to counter the issues around digital economy
- Other options have also been recommended as additional safeguards against BEPS by the task force (provided that they respect treaty obligations i.e. treaty override is avoided):
  - **Significant economic presence** *(implemented as amendment to s. 9 vide Finance Act, 2018)*
  - Withholding tax
  - **Equalisation levy**
- **Query: Does our equalisation levy result in treaty override?**

# 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
  - STT levied by Finance Act, 2004
  - CTT levied by Finance Act, 2013
  - 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.*

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- 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.*

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- 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.: expenditure incurred in a hotel stay – expenditure tax levied by the Centre, but luxury tax levied by the State
  - E.g.: land and building – property tax levied by the State, but income-tax on income from house property, and wealth tax levied by the Centre
  - E.g.: advertisements – 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

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- 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.*

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- 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

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- 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 of shares and DDT

- Legislative history and provisions
- Availability of treaty benefit
- Dividend Distribution Tax

# Buyback – legislative history

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## *Around 2000-01*

- 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)

# Buybackl tax introduced

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*AY 2013-14*

- S. 115QA inserted
  - '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

# S. 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

# S. 115QA – analysis

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- '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

# Treaty applicability *... contd.*



- 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
- Specific exemption provided u/s 10(34A) – Art 10 of the treaty need not be invoked hence
- Truly, this is an income of the shareholder, and not of the company

# Availability of treaty benefits *... cont.*

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- 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

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- 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

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- 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)

# Situs of intangibles

- Legal concepts
- 20th Century Finance, Calcutta Tramways decisions
- Decision of Delhi HC in Foster's case

# 20th Century – facts *(2000) 6 SCC 12*

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- Sales tax is leviable only on the outright sale of goods
- Vide 46th Constitutional Amendment, definition of 'sale' amended to include 'transfer of right to use' goods also.
- Therefore, lease becomes a 'deemed sale' – States can therefore levy sales tax on leases as well
- Contract of lease having been signed in one State, when the goods were put to use in another State – which State to levy sales tax?
- Question before the SC:
  - Whether a State can levy <u>sales tax on transfer of right to use goods</u> merely on the basis that the goods put to use are located within its State irrespective of the facts that, inter alia, the contract of transfer of right to use has been executed outside the State

# 20th Century – held *(2000) 6 SCC 12*

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- 20th Century Finance v State of Maharashtra *(2000) 6 SCC 12*

  "35. As a result of the aforesaid discussion our conclusions are these:

  (a) ...

  (b) The appropriate legislature by creating legal fiction can fix situs of sale. In the absence of any such legal fiction the situs of sale in case of the transaction of transfer of right to use any goods would be the place where the property in goods passes, i.e. where the written agreement transferring the right to use is executed.

  (c) Where the goods are available for the transfer of right to use the taxable event on the transfer of right to use any goods is on the transfer which results in right to use and the situs of sale would be the place where the contract is executed and not where the goods are located for use.

  [......]"

# Situs of Intangibles – Salmond



"The leading principle as to the local situation of rights is that they are situated where they are exercised and enjoyed. Rights over material things therefore have the same situation as those things themselves. The goodwill of a business is situated in the place where the business is carried on. Debts are in general situated in the place where the debtor resides since it is there that the creditor must go to get his money."

*- Salmond on Jurisprudence (12th Edn.)*

# Situs of Intangibles (contd.)

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**Calcutta Tramways Co. Ltd v Commissioner of wealth tax** (1972) 86 ITR 133 (SC):

- Issue:
  - Under section 6 of the Wealth Tax Act, 1957, for a non-resident, the value of assets located outside India was not to be taken into account for computing his wealth
  - Debenture loans were raised by the company in UK, while a charge was created on the assets of the company in India.
  - Question: whether the liability was deductible while computing the wealth of the assessee?
  - Held: since the debts were located outside India, the liability thereof was not deductible.

# Situs of Intangibles (contd.)

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**Calcutta Tramways Co. Ltd v Commissioner of wealth tax** (1972) 86 ITR 133 (SC):

- "Simple contract debts, including those owing under bills of exchange and promissory notes are situate where the debtor resides. A debtor company may for this purpose be resident in any country where it has a branch office.
- A specialty debt is in general an asset situate where the instrument is physically situate. In particular, a judgment debt is situate where the judgment is recorded. A debt secured by mortgage of land is in character primarily a debt, with an accessory right to resort to the land for payment, not an estate in the land measured by the amount of the debt; its locality as an asset of the mortgage is therefore to be determined prima facie under the rules relating to debts.
- A share in a partnership business and the goodwill of a business are each situate where the business is carried on."

- *Halsbury's Laws of England*, 3rd Edn.. Vol. 15, p. 58, para 115

# Situs of intangibles *... contd.*

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- **Dicey** on Conflict of Laws:

  "Although patents, trademarks and copyrights are classified as movables, they share some of the characteristics of immovables in the sense that the rights wich they confer are territorially limited It follows that a patent, a trademark or copyright is situate in the country whose law governs its existence."

  *(Para 22-051 – 14th Ed.)*

# Fosters Australia – Delhi High Court

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**Cub Pty Limited v UOI (2016) 388 ITR 617 (Del)**

- The petitioner owned various brands, including Foster's, which comprises trademarks, logos, devices, brand guidelines, advertising material, technology, and know-how, including recipes and brewing specifications
- It had licensed the Foster's brand to its Indian subsidiary, Foster's India, through a business license agreement that enabled Foster's India to market, brew, process, and package Foster's beer in India
- Foster's India, which was directly held by FBG India Holdings Ltd. Mauritius, was indirectly transferred to SAB Miller U.K., by virtue of a share agreement in which the Foster's trademarks and brand intellectual property (intangible assets) were also transferred to SAB Miller
- An exclusive, perpetual license relating to Foster's brewing IP was also transferred to the U.K. company. The sales and purchase agreement between the petitioner and SAB Miller was executed in Melbourne, Australia.

# Fosters Australia – issues

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*Provisions and questions:*

- Several treaties provide that capital gains would be taxable as per domestic law provisions
  - E.g.: Article 14 of India UK treaty
- Section 9 deems an income to accrue or arise in India if the income arises
  - Through or from
    - Property in India
    - Asset in India
    - Source of income in India
  - Though Transfer of capital asset situate in India
- Does income from transfer of Foster's trademarks and brand intellectual property satisfy any of these conditions?

# Fosters Australia – arguments

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- Assessee argued the intangible assets have no physical presence in India and therefore should be governed by the internationally accepted maxim of *mobilia sequuntur personam*
- Assessee said that this is a common law Latin doctrine that means that the situs of the owner of an intangible asset is the closest approximation of the situs of the intangible asset
- Revenue, in contrast, argued that the intangible assets were used, registered, and nurtured in India and therefore, had taken root in India and were subject to tax in India
- Because the intangible assets were located in India, the income arising from the transfer of the assets by a non-resident would be deemed taxable in India

# Fosters Australia – Delhi HC held

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- An intangible asset does not have a physical form and that it is difficult to determine its location
- In the absence of a local legislation, the principle of *mobilia sequuntur personam* must be followed
- This is an internationally accepted rule, unless it is altered by local legislation. Hence, the income accruing to the petitioner from the transfer of its right, title, or interest in and to the trademarks and brand IP is not taxable in India, because the owner assessee is located outside India

# Fosters Australia – analysis

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- *Mobilia sequuntur personam* applies only when on the basis of the nature of the property under question, it does not have a necessarily implied locality
  - "It follows, as a natural consequence of the rule which we have been considering, (that personal property has no locality), that the laws of the owner's domicil should in all cases determine the validity of every transfer, alienation, or disposition made by the owner, whether it be inter vivos, or be post mortem. **And this is regularly true, unless there is some positive or customary law of the country where they are situate, providing for special cases, (as is sometimes done), or from the nature of the property, it has a necessarily implied locality**." (*Story*, in *Conflict of Laws (4th Ed., 1852) pg. 383)*
- The principle applies only to <u>personal rights</u> and not to business assets.

# Fosters Australia – analysis

- The principle laid down in 20th Century, based on Salmond, and SC conclusion in Calcutta Tramways, based on Halsbury should apply
- Thus, the situs of a trademark which is used in India and is territorially linked only to India, is in India. Therefore, section 9(1)(i) is attracted.
- Therefore, in a treaty like Indo-UK treaty (supra), the transfer of trademark would be taxable in India under the treaty.

**Business situs theory:**

Where choses in action become integral parts of a foreign business, they may be taxed in foreign jurisdiction as per business situs theory – it is an established doctrine, the leading case being *New Orleans v. Stempel (1899) 175 US 309*

Thus, intangibles may acquire a situs for taxation other than the domicile of the owner where they have acquired a business situs elsewhere.

# How treaties overcome double taxation

- **Different definitions of source, and Article 21**
- **Overcoming double taxation**
- **Article 21**
- **Article 4**

# Source – different definition

- 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.

# Overcoming double taxation

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| 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. |

# Article 21 – Other income

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- 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 '<u>items of income … not dealt with</u>'
  - 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 '<u>wherever arising</u>' – 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.

# Article 4 – Residence

- Article 4 seeks to resolve the dispute around double residency
- Article 4(1) – residence to be based on domestic laws relating to domicile, residence etc.
- Article 4(2), 4(3) – tie breaker rules

# Article 4 – Temporal application

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- 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

# Article 4 – Temporal application *… contd.*

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- Case study: Analysis:
  - Period of dual residence – 1st April to 31st December
  - First tie-breaker – permanent home: Which date to apply the permanent home rule on–

    (i) on the date of alienation,

    (ii) throughout the period of dual residence, or

    (iii) 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 – Second sentence

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- 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
- 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

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- 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
- The Netherlands-France-Sweden example in the previous slide is also a three State situation that arises out of the interpretation of Article 4.

# Shipping Business and Art. 8

- Taxation of shipping business
- Article 8
- Case Study
- Art. 7 and 8

# Taxation of Shipping Business

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- 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

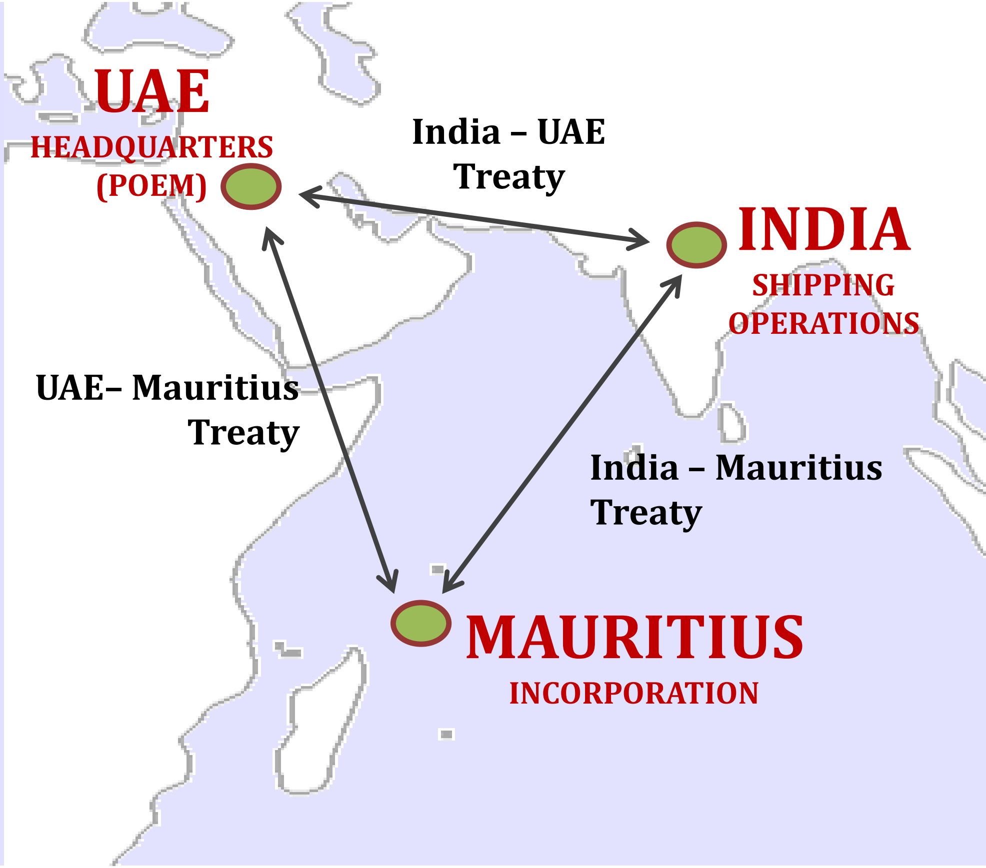
- OECD MC
  - Taxable in the country where the Place of Effective Management (POEM) is situated
- UN MC
  - Alternative A: Taxable in the country where the POEM is situated
  - Alternative B: Taxable in the country where  POEM situated unless shipping operations in the other country are **more than casual**. Otherwise, an appropriate allocation of net profits from shipping – taxed in source country.
- US MC
  - Taxable in the country where the enterprise is resident

*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

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- 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 does not apply
  → Article 7 *or* Income Tax Act 1961

# India – UAE Treaty

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- 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 *neither* a resident of UAE *nor* a resident of India
- India-UAE treaty does not apply
- Taxability in India → Mauritius-UAE treaty irrelevant

# Articles 7 and 8 – interplay

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- 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.**

# Secondary and corresponding adjustments

- Law relating to secondary and corresponding adjustments
- Section 92CE of the Income-tax Act, 1961

# Corresponding adjustment

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- Art 9(1) is the anchor for transfer pricing provisions
- 9(2) provides for corresponding adjustment (though referred in the treaties as "appropriate adjustment").
- Only Article to deal with adjustments made to two different legal entities.
  - Thus, only Article to deal with Economic Double Taxation Avoidance
  - Absent in many treaties – not part of the OECD Convention Draft of 1963

# Corresponding adjustment

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- Application of 9(2) presupposes
  - The primary adjustment is made in accordance with Article 9(1)
  - The adjustment is not a result of 'deliberation' manipulation of prices (OECD MC view critisised by authors as not flowing from text of Treaty)
- Article 9(2) provides for adjustment only if 'other State' satisfied with
  - Means
  - Methods and
  - quantum of adjustment
- This provides arbitrary powers to the other State, thereby it might disregard or disown its obligation under Article 9(2)

# Corresponding Adjustments *... contd.*

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- Suppose Article 9(1) exists in the treaty, and there are no TP provisions in the domestic law (as was the situation prior to AY 2001-02) – TP adjustments cannot be made on the strength of the treaty
- However, for corresponding adjustments under Article 9(2), no provision needed in domestic law?

# Corresponding adjustment

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Example:

- Infosys India Ltd. has a subsidiary in the USA – Infosys USA
- TP adjustment made on account of software export from Infosys India to Infosys USA, by the US IRS
- In view of Article 9(2) in the Indo-US treaty, Indian tax office should allow appropriate adjustments – even though there is no detailed machinery available

# Secondary adjustment – concept

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- OECD definition
  - "adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases"
  - Secondary transaction is a constructive transaction resulting from a primary adjustment.
  - Purpose – to make the actual allocation of profits consistent with the primary adjustment
  - Articles 9(1) and 9(2) do not deal with or provide for secondary adjustments
  - OECD says that there are too many variants and methods, there being no consensus, for providing secondary adjustments
  - In any case, substantive domestic law provision in needed. Even if a treaty provides for it, that is not enough.
    - Obvious reason: Treaty cannot create a liability!
    - PMP Auto Components v DCIT [2014] 66 SOT 42 (Mumbai - Trib.) / DIT v. Besix Kier Dhabhol [2012] 210 Taxman 151 (Bombay)

# Section 92CE of the Income-tax Act

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- S. 92CE inserted:
  - Requires secondary adjustment to be done if a primary adjustment has been made:
    - By the assessee suo motu
    - By the Assessing Officer
    - By an Advance Pricing Agreement (APA) or Mutual Agreement Procedure (MAP)
    - As per the Safe Harbour Rules
  - Deferred receivables
    - Excess money available with the AE, if not repatriated to India, deemed as an advance and interest to be computed on the same as prescribed

# Example 1

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- A (India) Ltd is a subsidiary of A (US) Ltd
- A India bought goods from A US at $10 per KG while ALP in India was $8 per KG.
- *Primary Adjustment*
  - India would dis-allow $2 being higher than ALP and tax A India accordingly
  - The transaction is still not as entered into between independent parties as $2 still available in US
- *Secondary adjustment* – Can India tax $2 as dividend/interest/royalty paid by A India to A US, and subject the same to tax in accordance with the treaty provisions (Arts. 10-12)
  - Absent the domestic law provisions, we cannot do so.
  - The domestic law will typically treat it as dividend / interest.

# Example 2

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- X (India) Ltd is a holding company of X (US) Ltd
- X US bought goods from X India at $ 25 per KG while ALP in US was $ 20 per KG.
- *Primary adjustment* - US would dis-allow $ 5 in the assessment of X US
- *Secondary adjustment* – Can India consider $5 as loan received by X India and impute notional interest in the hands of X US and tax X US accordingly

# Force of Attraction Rule

- The Concept
- Variants of FoA
- OECD v. UN v. US Model Conventions
- Other issues
- FoA under the Act Case Study

# Force of Attraction – the Concept

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- PE is not mere source based taxation
- Article 7(1) provides for taxation of income attributable to PE
- Citi Bank NA Bombay branch lending money to Singapore enterprise, interest received in India, is also taxable in India

# Profit attribution

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- Existence of a PE in a country leads to all profits derived from that country, *whether through the PE or not*, being treated as taxable in that country
- Philosophy: when an enterprise sets up a PE in a country, it submits itself to the fiscal jurisdiction of that country to a large extent

# Force of Attraction – OECD v. UN MC

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**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**

# Force of Attraction - Variants



- 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

# Other issues

- "Directly and indirectly"

> ... 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**.
>
> *Article 7(1) of India-UK DTAA*

- 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)**

# Other Issues … 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 DTAA*

# 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!**

# Force of Attraction – Indian Act

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- 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

# Force of Attraction

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- 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

- 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

# Case Study

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- A Ltd New Zealand has a construction project in India comprising
  - Offshore Supplies and Offshore services
  - Onshore supplies and construction services
- There is a construction PE in India
- Treaty has force of attraction
- Whether the answer will differ if Bank account maintained in India to which all proceeds are deposited

# THANK YOU!